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SIMPLIFICATION OF IMPUTED INTEREST RULES

MAY 14, 1985.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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Mr. ROSTENKOWSKI, from the Committee on Ways and Means, submitted the following

REPORT

[To accompany H.R. 2475]

[Including cost estimate of the Congressional Budget Office]

The Committee on Ways and Means, to whom was referred the bill (H.R. 2475) to amend the Internal Revenue Code of 1954 to simplify the imputed interest rules of sections 1274 and 483, and for other purposes, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

I. SUMMARY

Present Law

The Deficit Reduction Act of 1984 (the "1984 Act", P.L. 98-369) made two basic modifications to the Federal income tax treatment of imputed interest on seller-financing arising from the sale of property. First, the 1984 Act attempted to correct deficiencies in the then-existing imputed interest rules by providing that the amount of imputed interest would be determined by reference to an interest rate tied to the yields on U.S. Treasury obligations. Under these rules, if interest is not stated at a rate at least 110 percent of the average yield on Treasury obligations within an appropriate category of maturities (referred to as the applicable Federal rate), then interest is imputed into the transaction at a rate equal to 120 percent of the Federal rate. The effect of imputing interest income into the transaction is not to increase the amount paid by the buyer to the seller, but to recharacterize a portion of the payments (designated as principal by the parties) as interest for Federal income tax purposes.

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Second, the 1984 Act expanded the rules dealing with original issue discount to cover many deferred payment obligations arising from the sale of property. The purpose of this change was to ensure that the interest deduction taken by the buyer during a year does not exceed the interest income reported by the seller during that year.

In response to concerns expressed about the complexity of the 1984 Act rules, the Congress passed temporary legislation (called the "stopgap legislation", P.L. 98-612) at the end of the 98th Congress. Under the stopgap legislation, the test rate on the first $2 million of borrowed amounts is 9 percent on sales for exchanges of property occurring before July 1, 1985.

Committee Bill

Imputed interest rules

The committee bill provides that the rate used to determine whether there is adequate stated interest on the first $2 million of seller financing cannot exceed 9 percent. Where the amount of seller financing is greater than $4 million, that rate is 100 percent of the Federal rates. Where the amount of seller financing is between $2 million and $4 million, that rate is a blend of the 9 percent rate on an amount which phases out on a dollar-for-dollar basis as the amount of seller financing exceeds $2 million and 100 percent of the Federal rates on the excess. The $2 million and $4 million threshold amounts are indexed for inflation after 1988.

The committee bill also provides that the rate used to impute interest into the transaction is to be the same as the rate used to determine whether the stated interest is adequate (i.e., there would be no higher penalty rate where inadequate interest is stated). In addition, the Federal rates are to be determined on a monthly basis, and a rate for a month may be used for sales or exchanges occurring in that month and the next two succeeding months. The imputed interest rules will not apply to assumed loans.

Further, in certain transactions where the borrowed amount is not more than $2 million, the committee bill allows the parties to elect to account for interest in the transaction on the cash method of accounting. The election cannot be made if the seller is a dealer in the property sold or uses the accrual method of accounting.

The amendments by the committee bill to the imputed interest rules apply to sales and exchanges after June 30, 1985.

ACRS recovery period for real property

The committee bill extends the ACRS recovery period for real property (other than low-income real property) from 18 years to 19 years. This change generally would be effective for property placed in service after May 8, 1985. However, the longer recovery period would not apply to property placed in service after May 8, 1985, and before January 1, 1987, if the taxpayer entered into a binding contract to purchase or construct the property before May 9, 1985, or construction of the property had begun before May 9, 1985.

II. PRESENT LAW

A. The Original Issue Discount Rules

Treatment of original issue discount as interest

If, in a lending transaction, the borrower receives less than the amount to be repaid at the loan's maturity, then the difference represents "discount." Discount performs the same function as stated interest, i.e., compensation of the lender for the use of the lender's money.[1] Code sections 1272 through 1275 and section 163(e) (the "OID rules") generally require the holder of a debt instrument issued at a discount to include annually in income a portion of the original issue discount ("OID") on the instrument, and allow the issuer of such an instrument to deduct a corresponding amount, irrespective of the methods of accounting that the holder and the issuer otherwise use.[2]

Definitions

"Original issue discount" is defined as the excess of a debt instrument's "stated redemption price at maturity" over its "issue price" (provided such excess is not less than a certain *de minimis* amount).

"Issue price" is generally (1) in the case of a cash loan, the amount borrowed, (2) in the case of a debt instrument that is issued for property where either the debt instrument or the property is publicly traded,[3] the fair market value of the property, or (3) if neither the debt instrument nor the property exchanged for it is publicly traded, the amount determined under section 1274, as discussed below.

"Stated redemption price at maturity" includes all amounts payable at maturity excluding any interest based on a fixed rate and payable unconditionally over the life of the debt instrument at fixed intervals no longer than one year.

Operation of the OID rules

The amount of the OID in a debt instrument, if any, is allocated over the life of the instrument through a series of adjustments to the issue price for each "accrual period" (i.e., each six-month or shorter period ending on the calendar day corresponding to the date of the debt instrument's maturity and the date six months prior to the date of maturity). The adjustment to the issue price for each accrual period is determined by multiplying the "adjusted issue price" (i.e., the issue price increased by adjustments prior to the beginning of the accrual period) by the instrument's yield to maturity, and then subtracting the interest payable during the accrual period. The adjustment to the issue price for any accrual

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[1] *United States* v. *Midland-Ross Corp.*, 381 U.S. 54 (1965); *see also Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974).

[2] Prior to 1982, the OID rules applied only to a limited class of obligations. The Tax Equity and Fiscal Responsibility Act of 1982 and the 1984 Act greatly expanded the number and types of obligations to which the OID rules apply.

[3] Presently, only stock or securities traded on an established securities market are treated as publicly traded. However, section 103 of the Technical Corrections Act of 1985 (H.R. 1800) would grant the Treasury Department authority to issue regulations treating as publicly traded other property "of a kind regularly traded on an established market."

period is the amount of OID allocated to that accrual period. These adjustments reflect the amount of the accrued but unpaid interest on the debt instrument in each period. The holder is required to include this amount as interest income and the issuer is permitted a corresponding interest deduction.[4]

B. Determination of Issue Price in Debt-for-Property Transactions: Section 1274

In general

Section 1274, added by the 1984 Act, performs two roles. First, section 1274 tests the adequacy of stated interest in certain debt instruments issued for nonpublicly traded property and, where stated interest is inadequate, recharacterizes a portion of the principal of the debt instrument as interest. Second, section 1274 prescribes the issue price of the debt instrument. If the issue price so prescribed is less than the debt instrument's stated redemption price at maturity, the application of the OID rules will require the issuer and the holder of the debt instrument to use the accrual method of accounting for any interest (whether stated or imputed) that is not paid currently. Thus, the impact of section 1274 is to require the lender and borrower to account for interest annually in an amount equal to the greater of the stated interest rate or a rate deemed to be adequate (i.e., the "imputation rate," described below).

Subject to certain exceptions, described below, section 1274 determines the issue price of a debt instrument issued in connection with the sale or exchange of property if (1) neither the instrument nor the property received in exchange for the instrument is publicly traded; (2) some or all of the payments under the instrument are due more than six months after the sale; and (3) the stated redemption price at maturity of the instrument exceeds its stated principal amount (if there is adequate stated interest) or its "imputed principal amount" (if there is inadequate stated interest).

Determination of issue price and amount of OID under section 1274

The issue price of an obligation subject to section 1274 is the stated principal amount of the instrument unless there is inadequate stated interest. In order to determine whether stated interest is adequate, the stated principal amount of the debt instrument is compared with the "testing amount"—the amount determined by discounting all payments due under the instrument at a prescribed "test rate." An instrument contains adequate stated interest if the stated principal amount is less than or equal to the testing amount.

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[4] The premise of the OID rules is that, for Federal income tax purposes, an obligation issued at a discount should be treated like an obligation issued at par requiring current payments of interest. Accordingly, the effect of the OID rules is to treat the borrower as having paid semiannually the lender the interest accruing on the outstanding principal balance of the loan, thereby permitting the borrower to deduct as interest expense and requiring the lender to include in income such interest which has accrued but is unpaid. The lender is then deemed to have lent the accrued but unpaid interest back to the borrower, who in subsequent periods is deemed to pay interest on this amount as well as on the principal balance. This concept of accruing interest on unpaid interest is commonly referred to as the "economic accrual" of interest, or interest "compounding."

If a debt instrument does not contain adequate stated interest, section 1274 deems the principal amount (and the issue price) of the instrument to be the "imputed principal amount." The imputed principal amount is the amount determined by discounting all payments due under the instrument using a prescribed "imputation rate," which is higher than the test rate.

In effect, where section 1274 applies, if the debt instrument does not bear interest at a rate at least equal to the prescribed test rate, interest will be imputed at a higher rate. Moreover, if such interest is not unconditionally payable at least annually,[5] the OID rules will require periodic inclusion and deduction of the accrued but unpaid interest. The OID rules also apply if an instrument provides for adequate interest payable at least annually, but also provides for fixed additional amounts of interest that are not paid currently. In such a case, the instrument is deemed to contain OID equal to the additional interest. Pursuant to the OID rules, a portion of this OID is reported as income by the lender and deducted by the borrower currently.[6]

"Test rates" and "imputation rates"

Under section 1274, whether is adequate stated interest in a transaction is determined by reference to an appropriate test rate. The test rate for a debt instrument subject to section 1274 is the rate in effect on the first day there is a binding contract for the sale or exchange of the property. All test and imputation rates are applied using semiannual compounding.

General rule.—For sales or exchanges after December 31, 1984, of new property eligible for the investment credit, and for all sales or exchanges after June 30, 1985, the test rate is 110 percent of the "applicable Federal rate," and the imputation rate is 120 percent of the "applicable Federal rate."

Applicable Federal rate.—The applicable Federal rate ("AFR") for a debt instrument is the lower of two published rates, one specified by the 1984 Act and one specified in temporary Treasury regulations. The statutory rate is based on the weighted average of yields over a period of six months for marketable obligations of the United States Government with a comparable maturity. Such rates are redetermined at six-month intervals for three categories of debt instruments: short-term maturity (three years or less), mid-term maturity (more than three years but not in excess of nine years), and long-term maturity (more than nine years).[7]

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[5] As discussed below, the prescribed test rates are based on semiannual compounding. Accordingly, if interest is payable annually, the amount payable must reflect the compounding of the test rate. If interest is payable at intervals more frequent than semiannual, the nominal rate may be adjusted appropriately. For illustration of the adjustments to the prescribed rate based on the intervals at which interest is paid, *see, e.g.*, Rev. Rul. 85-58, 1985-8 I.R.B. 5.

[6] An exception from the accrual accounting requirement is provided for debt issued in connection with sales of property not eligible for the investment credit and used in the active trade or business of farming. This exception applies only if the sale takes place after December 31, 1984, and prior to July 1, 1985, and the borrowed amount does not exceed $2 million. Interest on such debt is accounted for by both the borrower and the lender on the cash method of accounting.

[7] Appropriate adjustments to the rates are to be made for application to debt instruments, the interest on which is wholly or partly exempt from tax (sec. 1288).

The rates determined under the temporary Treasury regulation are intended to reflect more accurately the current marketplace.[8] These rates are computed monthly using the same methodology described above, except that the rates reflect the average yields for one-month periods. In any month, the lower of the six-month rate or the monthly rate is the AFR. However, in cases where the monthly rate for either of the two preceeding months is lower than the AFR for a particular month, the test rate for that month is the lower of the two such rates.

Special rule for certain transactions before July 1, 1985.—For sales or exchanges after December 31, 1984, and before July 1, 1985, of property other than new property eligible for the investment credit, the test rate for "borrowed amounts" not exceeding $2 million is 9 percent. The test rate for borrowed amounts exceeding $2 million is a "blend" of 9 percent on the first $2 million and 110 percent of the AFR on the excess. In applying the $2 million limitation, all sales or exchanges that are part of the same transaction (or a series of related transactions) are treated as one transaction, and all debt instruments arising from the same transaction (or a series of related transactions) are treated as one debt instrument. The imputation rate for transactions during this same period is 10 percent for borrowed amounts to $2 million and a blend of 10 percent and 120 percent of the AFR for borrowed amounts exceeding $2 million.

Limitation on principal amount of a debt instrument

Notwithstanding the computation of "issue price" discussed above (and, accordingly, the buyer's basis in the property), the principal amount of any debt instrument under section 1274 in a "potentially abusive situation" is equal to the fair market value of the property sold.[9] This limitation applies whether the stated interest is adequate or inadequate under section 1274.

A potentially abusive situation includes any transaction involving a "tax shelter" (as defined in sec. 6661(b)(2)(C)(ii)). It also includes any other situation that, because of (1) recent sales transactions, (2) nonresource financing, (3) financing with a term beyond the economic life of the property, or (4) other circumstances, is of a type which the Treasury Department by regulation identifies as having a potential for abuse.

Exceptions

Specific exceptions are provided for certain debt instruments that otherwise would be subject to section 1274. However, these debt instruments may be subject to the rules of section 483. As discussed below, section 483 tests the adequacy of interest in a debt instrument without requiring annual inclusion and deduction of ac-

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[8] The mechanism provided by the temporary regulations is intended to respond to a problem that may exist where interest rates decline after the period in which the Federal rates were determined.

[9] The principal amount of the note is reduced to reflect the fair market value of other consideration involved in the transaction. This provision prevents both overstatement *and* understatement of the buyer's basis in the property. The purpose of the latter restriction is to prevent the intentional overstatement of OID. A taxpayer might be motivated to overstate the interest element of a sale, for example, if the property involved in the sale were nondepreciable or the seller were not subject to U.S. tax on interest income.

crued but unpaid interest. Debt instruments that are expected from section 1274 are as follows:

Personal-use property.—Issuers (but not holders) of debt instruments issued in exchange for property, substantially all of which will not be used by the issuer in a trade or business or held by the issuer for the production or collection of income, are excepted from section 1274. Accordingly, a cash-method issuer of such an obligation may claim interest deductions only for amounts of stated interest actually paid during the taxable year.

Annuities.—Section 1274 does not apply to an annuity to which section 72 applies and the liability for which depends in whole or in substantial part on the life expectancy of any individual. In addition, section 1274 does not apply to any annuity (whether or not dependent upon life expectancy) issued by an insurance company (subject to tax under Subchapter L), provided the annuity is issued (1) in a transaction in which only cash or another annuity contract meeting the requirements of this excpeiton is exchanged for the annuity, (2) upon exercise of an election under a life insurance policy by a beneficiary thereof, or (3) in a transaction involving a qualified pension or employee benefit plan.

Patents.—An exception is provided for payments attributable to a transfer of a patent, provided the transfer is eligible for capital gain treatment under section 1235 and such payments are contingent upon the productivity, use, or disposition of the patent. Thus, the exception does not apply in the case of a deferred lump-sum amount payable for a patent.

Farms.—Section 1274 does not apply to debt instruments received by an individual, estate, or testamentary trust, by a small business corporation (as defined in sec. 1244(c)(3)), or by certain partnerships[10] in exchange for a farm. This exception applies only if the sales price does not exceed $1 million.[11]

Principal residences—Debt instruments received by an individual as consideration for the sale or exchange of that individual's principal residence (within the meaning of sec. 1034) are not subject to section 1274, regardless of the amount involved in the transaction.

Total payments not exceeding $250,000—Section 1274 does not apply to any debt instrument given in exchange for property if the sum of (1) the payments due under the instrument (whether designated principal or interest) and under any other debt instrument given in the transaction, and (2) the fair market value of any other consideration given in the transaction, does not exceed $250,000.[12]

Land transfers between related persons.—Section 1274 does not apply to an instrument to the extent that section 483(f), relating to certain sales of land between related parties, applied.

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[10] That is, those partnerships whose capital is not in excess of the limits specified in sec. 1244(c)(3).

[11] Sales and exchanges that are part of the same transaction or a series of related transactions are treated as one sale or exchange, in order to prevent taxpayers from avoiding the $1 million limitation by dividing what is in substance a single transaction into two or more smaller transactions. The exception for farms as well as the exceptions following are nevertheless subject to sec. 483, as more fully discussed in the text below.

[12] This exception is subject to an aggregation rule similar to that provided under the farm sale exception.

C. Measurement of Principal and Interest in Transactions Not Subject to the OID Rules: Section 483

In general

Section 483 generally applies to nonpublicly traded debt instruments given in exchange for nonpublicly traded property where such debt instruments are not subject to section 1274. Under section 483, an instrument is tested for adequate stated interest in the same manner, and using the same test rates, as under section 1274. Where stated interest is inadequate, section 483 recharacterizes a portion of the principal amount of the instrument as interest which, in general, is equal to the additional amount of OID that section 1274 would impute.[13]

However, unlike section 1274, section 483 does not require imputed interest (or stated interest) to be accounted for on an accrual basis. Stated interest on a debt instrument subject to section 483 is accounted for under the taxpayer's usual method of accounting. Imputed interest is accounted for by cash-method taxpayers when the payments, portions of which are recharacterized as interest by section 483 are made, or by accrual-method taxpayers when such payments are due. The portion of the imputed interest that is allocated to a payment is that portion of the total imputed interest which, in a manner consistent with the method of computing interest under the OID rules, is properly allocable to such payment.

Exceptions

Excepted transactions.—Section 483 contains the same exceptions for sales of personal-use property, annuities, and patents that apply to section 1274. In addition, section 483 does not apply where the sales price of the property does not exceed $3,000.

Lower test rates.—In the case of a sale after June 30, 1985, of a principal residence where the purchase price does not exceed $250,000 or of farm land where the price does not exceed $1 million (where such sale would qualify for exception from section 1274), the test rate may not exceed 9 percent, and imputation rate may not exceed 10 percent. If the purchase price of a principal residence exceeds $250,000, these limits apply to the portion of the deferred payments that $250,000 bears to the sales price; the rates based on the AFR apply to the remainder. In addition, for sales or exchanges of land between an individual and that individual's brothers, sisters, spouse, ancestors or lineal descendants, the test rate under section 483 may not exceed 6 percent. This preferential rate applies only to the extent that the sales price of the land, and the sales price of all prior sales price of the land, and the sales price of all prior sales of land between the same individuals in a calendar year, does not exceed $500,000.

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[13] For certain transactions, lower test and imputation rates are provided. These transactions are described in the text below.

D. Regulatory Authority Relating to Debt-For-Property Transactions

The Treasury Department has authority to issue regulations dealing with the treatment of transactions involving varying interest rates, put or call options, indefinite maturities, contingent payments, assumptions of debt instruments not specifically dealt with in the statute, and other circumstances. The regulatory authority granted to the Treasury Department contemplates possible modification of the generally applicable rules where appropriate to carry out the purposes of the statute, including the provision of exceptions for transactions not likely to significantly reduce the tax liability of the purchaser by reason of overstatement of the basis of the acquired property.

Pursuant to its regulatory authority, the Treasury Department has provided the monthly rates in order to address the problems that may arise where the statutorily determined rates are significantly higher than prevailing market interest rates.

E. Assumptions of Debt in Connection With the Sale of Property

Neither section 483 nor section 1274 applies to the following debt obligations assumed in connection with the sale or exchange of property, or to debt obligations which property is taken subject to, provided that the terms and conditions of the obligation are not modified in connection with the sale:

Pre-October 16, 1984 obligations

Loans made on or before October 15, 1984, and assumed after December 31, 1984, in connection with a sale or exchange of property, are not subject to section 483 or section 1274 by reason of such assumption.[14] This exception does not apply, however, if the purchase price of the property exceeds $100 million.

Residences

Loans assumed in connection with a sale of a residence by an individual, estate, or testmentary trust are exempt from sections 483 and 1274 if either (1) at the time of the sale, the property was the seller's (or if applicable, the decedent's) principal residence (within the meaning of sec. 1034) or (2) during the two-year period prior to the sale, no substantial portion of the property was of a character subject to an allowance for depreciation. Thus, an assumption of a loan in connection with the sale of a principal residence, or of a vacation home on which a taxpayer may not claim depreciation (e.g., by reason of sec. 280A), generally is not subject to testing for unstated interest under sections 483 or 1274. This exception does not apply, however, to a sale of property that was at any time held by the seller for sale to customers in the ordinary course of business.

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[14] The exceptions relating to assumptions of loans also apply to loans which property may be taken subject to.

Farms

Neither sections 483 or 1274 apply to loans assumed in connection with a sale by a "qualified person" of real property used as a farm (within the meaning of sec. 6420(c)(2)) at all times during the three-year period prior to the sale. The exception also applies to loans assumed in connection with the sale of tangible personal property used by the seller of such a farm in the active conduct of a farming business that is also sold in connection with the sale of such a farm for use by the buyer in the active conduct of a farming business. The term "qualified person" includes an individual, estate, or testamentary trust, or a corporation or partnership having 35 or fewer shareholders or partners immediately prior to the sale or exchange, owning at least a 10-percent interest in the property sold.

Trades or businesses

Loans assumed in connection with a sale by a "qualified person" of a trade or business are exempt from sections 483 and 1274. Trade or business has the same meaning as under section 355, except that the rental of real estate under no circumstances qualifies as an active business for this purpose. For purposes of this exception, the term "qualified person" has the same meaning as in the exception for assumptions in connection with the sale of farm properties except that the sale must constitute a disposition of the seller's entire interest in the trade or business and in all substantially similar trades or businesses.

An exception is also provided for a sale of real property used in an active trade or business (as defined above) by someone who would be a qualified person but for the fact that this entire interest in the trade or business is not being sold. Thus, for example, loans assumed in connection with a casual sale by a sole proprietor of real property used in his business could be exempt from sections 1274 and 483.

The trade or business property exception does not apply to a sale of property qualifying under the farm exception, or to property that is new property eligible for the investment credit in the buyer's hands.

F. Cost Recovery Deductions For Real Property

In general, domestic real property placed in service after March 15, 1984, and qualifying as recovery property, may be depreciated on an accelerated basis under ACRS over an 18-year period, under tables of recovery percentages prescribed by the Treasury Department. These tables reflect a "mid-month" convention for property placed in service after June 22, 1984. Taxpayers may also elect to depreciate such property on a straight-line basis over 18, 35, or 45 years. The recovery period uder ACRS for low-income housing described in sections 1250(a)(1)(B) (i), (ii), (iii) or (iv) is 15 years and no mid-month convention is used.

Under transitional rules provided by the 1984 Act, property placed in service after March 15, 1984, pursuant to binding contracts entered into, or where construction was commenced by or for the taxpayer, prior to March 16, 1984, may be eligible for a 15-year

recovery period. Special rules under the 1984 Act are also provided relating to components of real property placed in service prior to March 16, 1984, that are placed in service on or after that date.[15]

III. REASONS FOR CHANGE

In general

The imputed interest rules of the 1984 Act have been perceived as complex in several respects. The changes made by the committee bill attempt to simplify the imputed interest rules, while retaining the basic purposes of the 1984 legislation.

The imputed interest rate

The committee believes that taxpayers entering into smaller transactions should not have to keep track of the fluctuating imputed interest rates prescribed by the 1984 Act. Accordingly, the committee bill provides a single maximum test rate of 9 percent for transactions where the amount of seller financing does not exceed $2 million. In addition, in order not to create unfairness where the size of the transaction is slightly above the $2 million threshold amount, the committee bill phases out the 9-percent rate on a dollar-for-dollar basis on amounts between $2 million and $4 million.

The definition of the AFR provided by the Act was intended to be a current measure of minimum borrowing rates for a given range of maturities. The mechanism for determining the AFR under the 1984 Act (and the temporary Treasury regulations), however, lags somewhat behind the market. For example, where interest rates are falling rapidly, it is possible for the appropriate borrowing rates for a particular transaction to be slightly lower than 110 percent of the AFR. Accordingly, the committee believes that it is appropriate to reduce the imputed interest rate to 100 percent of the AFR.

The committee believes that an imputed interest rate of 100 percent of the AFR (for transactions not eligible for the lower fixed test rate) is a fair minimum rate and one which will not impose hardships on taxpayers. In recognition that there might be certain isolated circumstances in which a different rate would be more appropriate, the committee bill grants the Treasury Department authority to issue regulations that would permit taxpayers to demonstrate that a lower rate is more accurate in proper cases.

The committee also believes that it is an unnecessary and needless complication to maintain the dual mechanism for determining the AFR that is currently provided by the 1984 Act and temporary Treasury regulations. The mechanism provided by the regulations has worked adequately to provide a rate which is current, yet because of the three-month period that a taxpayer may use the rate, is stable. Consequently, the committee bill eliminates the six-month rate.

Finally, the committee believes that the higher imputation provided by the 1984 Act often acted as a penalty for uninformed taxpayers. Knowledgeable taxpayers could always avoid the higher im-

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[15] Sec. 168(f)(1).

putation rate by providing for stated interest at a lower test rate. Accordingly, the committee bill eliminates the higher imputation rate.

Method of accounting

The 1984 Act attempted to prevent mismatching of interest income and interest deductions by requiring both the buyer and the seller to account for the interest in the transaction on the accrual method of accounting. Nevertheless, calculating and accounting for accrued but unpaid interest may impose hardship on taxpayers who might have to report taxable income in advance of receiving cash with which to pay the tax. This aspect is inconsistent with the committee's intention to relieve smaller transactions from complexity. Therefore, the committee bill permits taxpayers in certain smaller transactions to elect to use the cash receipts and disbursements method of accounting for interest income and expense, provided that both buyer and seller jointly agree to do so.

Assumptions

While the changes that the 1984 Act made in the imputed interest rules were in large part intended to stop abuses that result from the manipulation of principal and interest in a debt instrument arising from a seller-financed sale of property, many taxpayers have argued that the assumption of a debt instrument does not present the same potential for abuse as does a seller-financed debt instrument because where a debt instrument is assumed and its terms are not modified in connection with the transaction, there is no opportunity for the parties to manipulate principal and interest on the loan. Accordingly, under the committee bill, the imputed interest rules generally will not apply to assumptions of loans.

ACRS recovery period for real property

The committee believes that, in light of the current budget deficit of the Federal Government, there should be an offset for the revenue loss resulting from the changes the committee bill makes to the imputed interest rules (much of which results from transactions involving real property.) The committee also believes that the useful life of most real property exceeds 18 years and that an increase in the cost recovery period for real property would more correctly measure the income from real property. Accordingly, to maintain revenue neutrality, the committee bill would extend the ACRS recovery period of real property (other than low-income housing) from 18 years to 19 years.

IV. EXPLANATION OF THE BILL

A. The Imputed Interest Rate

In general

The committee bill makes four basic changes to the imputed interest rates. First, the committee bill reduces the test rate from 110 percent of the AFR to 100 percent of the AFR. Second, the committee bill provides for lower imputed interest rates for certain smaller transactions. Third, the committee bill provides that the imputa-

tion rate would be the same as the test rate (i.e., there would be no higher "penalty rate" where inadequate interest is stated). Finally, the committee bill would revise the computation of the AFR from a semiannual rate to a monthly rate.

Lower overall imputed interest rate

Under the committee bill, the imputed interest rate (i.e., the test rate and the imputation rate) is reduced to 100 percent of the AFR.

Lower imputed interest rates for certain smaller transactions

The committee bill places a limit on the imputed interest rates in smaller transactions which do not involve new property eligible for the investment tax credit. Under these rules, where the amount of seller financing [16] does not exceed $4 million, the committee bill provides that the imputed interest rate cannot exceed 9 percent.[17] Where the amount of seller financing exceeds $2 million but is less than $4 million, the imputed interest rate is a "blend" of 9 percent on a specified portion of the seller financing and the 100 percent of the AFR on the remainder. The portion of the seller-financing eligible for the 9 percent rate is equal to $2 million reduced dollar-for-dollar by the amount of seller financing over $2 million. For example, if the amount of seller financing were $2.5 million, the emputed interest rate would be the weighted average of 9 percent on $1.5 million (i.e., $2 million reduced by the excess of $2.5 million over $2 million) and the AFR on the remaining $1 million.[18] Where the amount of seller financing is $4 million or more, the imputed interest rate is the equal to 100 percent of the AFR. The $2 million and $4 million "thresholds" will be indexed for inflation beginning after 1988.

For sales of new property eligible for the investment credit, the imputed interest rate for a seller-financed debt instrument is equal to the AFR regardless of the amount of seller financing.

Elimination of the penalty rate

Under the committee bill, the imputation rate for a debt instrument that fails to state adequate interest will be the same as the test rate for that instrument. Accordingly, there is only one "imputed interest rate" for a transaction and there is no separate "penalty rate" where a debt instrument does not state adequate interest for any reason.

Determination of the applicable Federal rate

Under the committee bill, the sole mechanism for determining the AFR will be the one currently prescribed by the temporary Treasury regulations. The alternative mechanism under present law for determining the six-month rate prescribed by the 1984 Act will be eliminated.

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[16] The amount of seller financing is measured by the stated principal amount of the seller-financed debt instrument.

[17] As under prior law, all rates are compounded semiannually.

[18] The weighted average in the example may be computed as follows, assuming an AFR of 11.5 percent: 9 percent times 0.6 (i.e., $1.5 million divided by $2.5 million) plus 11.5 percent times 0.4 (i.e., $1.0 million divided by $2.5 million) equals 10 percent.

Under these revised rules, the AFR will be computed using the same methodology as under present law, except that the rates will be determined on a monthly basis and the rate will reflect the average yields for one-month periods. In addition, the AFR for a particular month may be used as the imputed interest rate for that month and the next two succeeding months.

Regulatory authority

Aggregation rules.—The Committee bill authorizes the Treasury Department to issue regulations specifying the circumstances in which transactions will be treated as "part of the same transaction or related transactions" for the purpose of applying the $2 million and $4 million limitations. These regulations will address transactions involving multiple sellers, multiple buyers, "pass-through" entities, and one transaction structured as a series of small transactions. It is anticipated that the regulations will aggregate transactions in which multiple buyers or multiple sellers are acting in concert. The committee intends, however, that these regulations would provide that multiple sales by a taxpayer who is a dealer in the property sold, to unrelated buyers in otherwise unrelated transactions (such as typically occurs when a home builder sells homes in unrelated transactions to different home buyers) would not be aggregated.

Lower rates.—The committee bill also provides that the Treasury Department is authorized to issue regulations under which taxpayers would be permitted to demonstrate that, in appropriate circumstances, a rate lower than the AFR provided by the statute, but calculated according to the same principles as the AFR, is a more appropriate imputed interest rate for a particular debt instrument. For example, it may be appropriate to use a lower rate where the borrower can demonstrate that it can borrow in the open market at a rate less than the AFR applicable to that maturity of the debt instrument for which the imputed interest rate is to be applied.

Coordination with other Code provisions.—The Treasury Department is authorized to issue regulations regarding the relationship of the imputed interest provisions to other Code provisions. The committee intends to limit the benefit of the lower test rate (provided by section 1274A) to bona fide sales of property between unrelated parties. Accordingly, the regulations may provide that section 1274A would not apply to certain transactions undertaken to avoid other provisions of the Code that require an arm's-length interest rate. For example, where a corporation purchases $2 million of nonpublicly traded debt yielding a rate equal to the AFR and sells that debt obligation to its shareholders for a note paying interest at 9 percent, the committee understands that the requlations would provide that there would be additional interest income to the corporation. The committee anticipates that the Treasury Department will exercise the regulatory authority granted by the 1984 Act to provide rules under which contingent payments (e.g., payments based on future sales or rental receipts) may be taken into account in determining whether or not a debt instrument has adequate stated interest in transactions that would not thereby be subject to abuses. In addition, the committee intends that the Treasury Department's 1984 Act regulatory authority will be exer-

cised with regard to situations where the OID rules are avoided as a result of prearranged or systematic discounting of seller-financed debt instruments.

B. Method of Accounting

The "cash-cash" election

The commitee bill provides that, in the case of certain debt instruments that otherwise would be subject to section 1274, interest income and expense arising from such debt instruments may be accounted for on the cash receipts and disbursements method of accounting. To be eligible for such treatment, (1) the stated principal amount of the debt instrument cannot exceed $2 million, (2) the debt instrument must arise from the sale of property by a cash-basis taxpayer who is not a dealer in the type of property sold, and (3) the lender and the borrower must jointly elect such treatment.[19] A debt instrument meeting these requirements is to be known as a "cash-method debt instrument."

Transfers and assumptions of cash-method debt instruments

Special rules are provided relating to the treatment of taxpayers who are the successors to either the issuer or holder of a cash-method debt instrument. Generally, such a successor shall also be required to use the cash receipts and disbursements method of accounting for interest income and expense arising from the cash-method debt instrument. Accordingly, where an accrual-method taxpayer assumes the liability on a cash-method debt instrument, that taxpayer must use the cash method to account for interest expense arising from the instrument. An exception is provided where a cash-method debt instrument is transferred to a subsequent holder who uses the accrual method of accounting. In this case, the exception requires the subsequent holder to continue to use his normal method of accounting (i.e., to use the accrual method).

Regulatory authority

The Treasury Department is authorized to issue regulations prescribing rules to prevent abuses of the special treatment afforded to cash-method debt instruments. The committee intends that the delegation of regulatory authority will be exercised only to prevent abuse situations.

One situation that such regulations may address is the timing of deductions for interest on indebtedness incurred or continued to acquire or carry a cash-method debt instrument. Another situation that may be addressed is one where a cash-method debt instrument remains outstanding when the property, the initial sale of which gave rise to the cash-method debt instrument, is resold in a transaction involving a seller-financed debt instrument.

A third situation which the regulations may address relates to the treatment of transfers of cash-method debt instruments. It is ancticipated that these regulations will clarify existing law regard-

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[19] The Committee intends that, until regulations are issued specifying a different method of election, the parties can make the election by so indicating in their respective tax returns and stating the election clearly in the debt instrument.

ing (1) the amount and character of gain realized on disposition of a cash-method debt instrument, (2) the allocation of payments on the debt instrument between income and recovery of basis for a subsequent holder, and (3) the timing of interest deductions for, and the allocation of interest deductions between, the initial issuer and a taxpayer who assumes the issuer's obligations on a cash-method debt instrument.[20]

C. Assumptions

Under the committee bill, if an existing debt instrument is assumed in connection with the sale or exchange of property (or if the property is acquired subject to an existing debt instrument), section 1274 and section 483 do not apply to such existing debt instrument by reason of such assumption (or acquisition) unless the terms of the existing debt instrument are modified in connection with the transaction or the nature of the transaction is changed.[21] If only minor modifications are made in the terms of the loan, the committee does not intend that the imputed interest rules will be applied.

Under temporary Treasury regulations, for installment reporting purposes, a so-called wrap-around debt instrument may be treated like an assumption of the so-called "wrapped" (or underlying debt). However, many taxpayers have taken the contrary position. The committee believes that a wrap-around debt should be treated consistently for purposes of the installment reporting and imputed interest rules. The committee does not wish to address the proper treatment of wrap-around debt for installment reporting at this time. Moreover, the committee wishes to avoid the situation where the seller takes the position that the wrap-around debt does not result in immediate taxation, while the buyer takes the position that the entire amount of the wrap-around debt is exempt from the imputed interest rules. Accordingly, until and unless it is ultimately settled that a wrap-around debt instrument is treated as an assumption for installment reporting purposes, the committee intends that the exception in the committee bill relating to assumptions should not apply to wrap-around debt instruments.

D. Accelerated Cost Recovery System

Under the committee bill, the minimum recovery period for domestic real property qualifying as recovery property is increased from 18 years to 19 years. This change in the recovery period does not affect the ACRS provisions relating to low-income housing.

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[20] *See, e.g., United States* v. *Midland-Ross Corp.*, 381 U.S. 54 (1965); Treas. Reg. sec. 1.61-7; Code secs. 1276, *et seq.*

[21] The committee intends that the nature of the transaction is to be considered changed if, for example, the loan which is to be assumed arose in a transaction that was excepted from section 483, but the subsequent transaction does not qualify for the exception. *See, e.g.,* Treas. Reg. sec. 1.483-1(f)(6)(iv) (Example 4).

E. Effective Dates

Imputed interest rules

The provisions of the committee bill relating to the amendment of the imputed interest rules are effective for sales or exchanges occurring after June 30, 1985.

ACRS recovery period for real property

The provision of the committee bill relating to the ACRS recovery period for real property is generally effective for property placed in service after May 8, 1985. Transitional rules similar to those under the 1984 Act are provided for property that is placed in service after May 8, 1985, and before January 1, 1987, where there was a binding contract to construct or acquire the property, or where construction was begun by or for the taxpayer before May 9, 1985. Special rules apply to components placed in service after May 8, 1985.[22]

V. EFFECT OF THE BILL ON THE BUDGET AND VOTE OF THE COMMITTEE IN REPORTING THE BILL

Budget Effects

In compliance with clause 7 of Rule XIII of the Rules of the House of Representatives, the following statement is made about the effect on the budget of this bill, H.R. 2475, as reported.

The bill is estimated to have the following effect on fiscal year budget receipts:

[Fiscal years, millions of dollars]

	1985	1986	1987	1988	1989	1990
Imputed interest changes	−5	−58	−153	−172	−205	−235
ACRS recovery period for real property	+5	+30	+91	+166	+255	+344
Net revenue effect	0	−28	−62	−6	+50	+109

The Treasury Department agrees with this statement.

Vote of the Committee

In compliance with clause 2(l)(2)(B) of Rule XI of the Rules of the House of Representatives, the following statement is made about the vote of the committee on the motion to report the bill. The bill, H.R. 2475, was ordered favorably reported by voice vote.

VI. OTHER MATTERS TO BE DISCUSSED UNDER HOUSE RULES

In compliance with clause 3(l)(3) and 2(l)(4) of Rule XI of the Rules of the House of Representatives, the following statements are

[22] Sec. 168(f)(1).

made with respect to the committee action on H.R. 2475, as reported.

Oversight Findings

With respect to subdivision (A) of clause 2(l)(3) (relating to oversight findings), the committee advises that it was as a result of the committee's oversight activities with respect to imputed interest rules of the Internal Revenue Code of 1954 that the committee concluded that it is appropriated to enact the provisions contained in the bill. The committee held a public hearing on imputed interest rules and related revenue matters on April 24, 1985.

New Budget Authority and Tax Expenditures

With respect to subdivision (B) of clause 2(l)(3), after consultation with the Director of the Congressional Budget Office, the committee states that the changes made to existing law by this bill involve no new budget authority.

The bill involves increased tax expenditures (relating to the imputed interest rule changes) for fiscal years 1985–1990, as follows: $5 million for 1985, $58 million for 1987, $172 million for 1988, $205 million for 1989, and $235 million for 1990. Also, the bill involves decreased tax expenditures (relating to ACRS cost recovery for real property) for fiscal years 1985–1990, as follows: $5 million for 1985, $30 million for 1986, $91 for 1987, $166 million for 1988, $255 million for 1989, and $344 million for 1990. Overall, for the fiscal years 1985–1990, the bill will involve a net reduction in tax expenditures of $63 million.

Consultation With Congressional Budget Officials on Budget Estimates

With respect to subdivision (C) of clause 2(l)(3), the committee advises that the Director of the Congressional Budget Office has examined the committee's budget estimates (as indicated in part IV of this report) and submitted the following statement:

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, May 10, 1985.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has examined an imputed interest bill that was ordered reported by the Committee on Ways and Means on May 8, 1985, which would replace stopgap legislation concerning income tax treatment of seller-financed real estate sales due to expire July 1, 1985. The bill would maintain more lenient treatment of seller-financed loan amounts below $2 million while phasing in higher imputed interest rates for larger transactions. The rates are capped at 100 percent of the applicable federal interest rate for principal loan amounts above $4 million. In addition, the bill would also lengthen the depreciation period for structures to offset the costs of applying lower imputed rates.

We have reviewed and concur with the estimates of the revenue effects of the bill prepared by the staff of the Joint Committee on Taxation shown below:

Revenue effect of the bill:

Fiscal year:	*Millions*
1985	0
1986	−$28
1987	−62
1988	−6
1989	+50
1990	+109

If you wish further details on this estimate, we will be pleased to provide them. With best wishes.

Sincerely,

ROSEMARY MARCUSS
(For Rudolph G. Penner, Director).

Oversight by Committee on Government

With respect to subdivision (D) of clause 2(l)(3), the committee advises that no oversight findings or recommendations have been submitted to the committee by the Committee on Government Operations regarding the subject of this bill.

Inflationary Impact

In compliance with clause 2(l)(4), the committee states that the enactment of this bill is not expected to have an overall inflationary impact on prices and costs in the operation of the national economy, as net effect of the bill is estimated to be revenue neutral over the next 5 years.

VII. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3 of Rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, H.R. 2475 as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

INTERNAL REVENUE CODE OF 1954

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Subtitle A—Income Taxes

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CHAPTER 1—NORMAL TAXES AND SURTAXES

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Subchapter A—Determination of Tax Liability

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PART IV—CREDITS AGAINST TAX

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Subpart E—Rules for Computing Credit for Investment in Certain

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SEC. 47. CERTAIN DISPOSITIONS, ETC., OF SECTION 38 PROPERTY.

(a) GENERAL RULE.—Under regulations prescribed by the Secretary—

(1) EARLY DISPOSITION, ETC.—If during any taxable year any property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the useful life which was taken into account in computing the credit under section 38, then the tax under this chapter for such taxable year shall be increased by an amount equal to the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from substituting, in determining qualified investment, for such useful life the period beginning with the time such property was placed in service by the taxpayer and ending with the time such property ceased to be section 38 property.

(2) PROPERTY BECOMES PUBLIC UTILITY PROPERTY.—If during any taxable year any property taken into account in determining qualified investment becomes public utility property (within the meaning of section 46(c)(3)(B)), then the tax under this chapter for such taxable year shall be increased by an amount equal to the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from treating the property, for purposes of determining qualified investment, as public utility property (after giving due regard to the period before such change in use). If the application of this paragraph to any property is followed by the application of paragraph (1) to such property, proper adjustment shall be made in applying paragraph (1).

(3) PROPERTY CEASES TO BE PROGRESS EXPENDITURE PROPERTY.—

(A) IN GENERAL.—If during any taxable year any property taken into account in determining qualified investment under section 46(d) ceases (by reason of sale or other disposition, cancellation or abandonment of contract, or otherwise) to be, with respect to the taxpayer, property which, when placed in service, will be new section 38 property, then the tax under this chapter for such taxable year shall be increased by an amount equal to the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from reducing to zero the qualified investment taken into account with respect to such property.

(B) CERTAIN EXCESS CREDIT RECAPTURED.—Any amount which would have been applied as a reduction of the qualified investment in property by reason of paragraph (4) of section 46(c) but for the fact that a reduction under such paragraph cannot reduce qualified investment below zero

shall be treated as an amount required to be recaptured under subparagraph (A) for the taxable year in which the property is placed in service.

(C) CERTAIN SALES AND LEASEBACKS.—Under regulations prescribed by the Secretary, a sale by, and leaseback to, a taxpayer who, when the property is placed in service, will be a lessee to whom section 48(d) applies shall not be treated as a cessation described in subparagraph (A) to the extent that the qualifed investment which will be passed through to the lessee under section 48(d) with respect to such property is not less than the qualified progress expenditures properly taken into account by the lessee with respect to such property.

(D) COORDINATION WITH PARAGRAPHS (1) AND (5).—If, after property is placed in service, there is a disposition or other cessation described in paragraph (1), or a disposition, cessation, or change in expected use described in paragraph (5), then paragraph (1) or (5), as the case may be, shall be applied as if any credit, which was allowable by reason of section 46(d) and which has not been required to be recaptured before such disposition, cessation, or change in use were allowable for the taxable year the property was placed in service.

(4) SPECIAL RULES FOR COMMUTER HIGHWAY VEHICLES.—

(A) USEFUL LIFE.—For purposes of this subsection, 3 years shall be treated as the useful life which was taken into account in computing the credit under section 38 with respect to any commuter highway vehicle (as defined in section 46(c)(6)(B)).

(B) CHANGE IN USE.—If less than 80 percent of the mileage use of any commuter highway vehicle by the taxpyer during that portion of any taxable year which is within the first 36 months of the operation of such vehicle by the taxpayer meets the requirements of section 46(c)(6)(B), then the tax under this chapter for such taxable year shall be increased by an amount equal to the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from treating such vhehicle, for purposes of determining qualified investment, as not being a commuter highway vehicle. If the application of this subparagraph to any property is followed by the application of paragraph (1) to such property, proper adjustment shall be made in applying paragraph (1).

(5) SPECIAL RULES FOR RECOVERY PROPERTY.—

(A) GENERAL RULE.—If, during any taxable year, section 38 recovery property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer before the close of the recapture period, then, except as provided in subparagraph (D), the tax under this chapter for such taxable year shall be increased by the recapture percentage of the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from reducing to zero the qualified investment taken into account with respect to such property.

(B) RECAPTURE PERCENTAGE.—For purposes of subparagraph (A), the recapture percentage shall be determined in accordance with the following table:

If the recovery property ceases to be section 38 property within—	The recapture percentage is:	
	[For 15-year, 10-year, and 5-year property] *For property other than 3-year property*	For 3-year property
One full year after placed in service	100	100
One full year after the close of the period described in clause (i)	80	66
One full year after the close of the period described in clause (ii)	60	33
One full year after the close of the period described in clause (iii)	40	0
One full year after the close of the period described in clause (iv)	20	0

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SEC. 48. DEFINITIONS; SPECIAL RULES.

(a) SECTION 38 PROPERTY.—

(1) IN GENERAL.—* * *

* * * * * * *

(g) SPECIAL RULES FOR QUALIFIED REHABILITATED BUILDINGS.—For purposes of this subpart—

(1) QUALIFIED REHABILITATED BUILDING DEFINED.—

(A) IN GENERAL.—The term "qualified rehabilitated building" means any building (and its structural components)—

(i) which has been substantially rehabilitated,

(ii) which was placed in service before the beginning of the rehabilitation, and

(iii) 75 percent or more of the existing external walls of which are retained in place as external walls in the rehabilitation process.

(B) 30 YEARS MUST HAVE ELAPSED SINCE CONSTRUCTION.—In the case of a building other than a certified historic structure, a building shall not be a qualified rehabilitated building unless there is a period of at least 30 years between the date the physical work on the rehabilitation began and the date the building was first placed in service.

(C) SUBSTANTIALLY REHABILITATED DEFINED.—

(i) IN GENERAL.—For purposes of subparagraph (A)(i), a building shall be treated as having been substantially rehabilitated only if the qualified rehabilitation expenditures during the 24-month period selected by the taxpayer (at the time and in the manner prescribed by regulations) and ending with or within the taxable year exceed the greater of—

(I) the adjusted basis of such building (and its structural components), or

(II) $5,000.

The adjusted basis of the building (and its structural components) shall be determined as of the beginning of the first day of such 24-month period, or of the holding period of the building (within the meaning of section 1250(e)), whichever is later. For purposes of the preceding sentence, the determination of the beginning of the holding period shall be made without regard to any reconstruction by the taxpayer in connection with the rehabilitation.

(ii) SPECIAL RULE FOR PHASED REHABILITATION.—In the case of any rehabilitation which may reasonably be expected to be completed in phases set forth in architectural plans and specifications completed before the rehabilitation begins, clause (i) shall be applied by substituting "60-month period" for "24-month period".

(iii) LESSEES.—The Secretary shall prescribe by regulation rules for applying this provision to lesses.

(D) RECONSTRUCTION.—Rehabilitation includes reconstruction.

(E) ALTERNATIVE TEST FOR DEFINITION OF QUALIFIED REHABILITATED BUILDING.—The requirement in clause (iii) of subparagraph (A) shall be deemed to be satisfied if in the rehabilitation process—

(i) 50 percent or more of the existing external walls of the building are retained in place as external walls.

(ii) 75 percent or more of the existing external walls of such building are retained in place as internal or external walls, and

(iii) 75 percent or more of the existing internal structural framework of such building is retained in place.

(2) QUALIFIED REHABILITATION EXPENDITURE DEFINED.—

(A) IN GENERAL.—The term "qualified rehabilitation expenditure" means any amount properly chargeable to capital account which is incurred after December 31, 1981—

(i) for real property (or additions or improvements to real property) which have a recovery period (within the meaning of section 168) of [18] *19* (15 years in the case of low-income housing) years, and

(ii) in connection with the rehabilitation of a qualified rehabilitated building.

(B) CERTAIN EXPENDITURES NOT INCLUDED.—The term "qualified rehabilitation expenditure" does not include—

(i) ACCELERATED METHODS OF DEPRECIATION MAY NOT BE USED.—Any expenditures with respect to which an election has not been made under section 168(b)(3) (to use the straight-line method of depreciation). The preceding sentence shall not apply to any expenditure to the extent subsection (f)(12) or (j) of section 168 applies to such expenditure.

(ii) COST OF ACQUISITION.—The cost of acquiring any building or interest therein.

(iii) ENLARGEMENTS.—Any expenditure attributable to the enlargement of an existing building.

(iv) CERTIFIED HISTORIC STRUCTURE, ETC.—Any expenditure attributable to the rehabilitation of a certified historic structure or a building in a registered historic district, unless the rehabilitation is a certified rehabilitation (within the meaning of subparagraph (C)). The preceding sentence shall not apply to a building in a registered historic district if—

(I) such building was not a certified historic structure,

(II) the Secretary of the Interior certified to the Secretary that such building is not of historic significance to the district, and

(III) if the certification referred to in subclause (II) occurs after the beginning of the rehabilitation of such building, the taxpayer certifies to the Secretary that, at the beginning of such rehabilitation, he in good faith was not aware of the requirements of subclause (II).

(v) EXPENDITURES OF LESSEE.—Any expenditure of a lessee of a building if, on the date the rehabilitation is completed, the remaining term of the lease (determined without regard to any renewal periods) is less than [18] *19* years (15 years in the case of low-income housing).

(vi) TAX-EXEMPT USE PROPERTY—

(I) IN GENERAL.—Any expenditure in connection with the rehabilitation of a building which is allocable to that portion of such building which is (or may reasonably be expected to be) tax-exempt use property (within the meaning of section 168(j)(3)).

(II) CLAUSE NOT TO APPLY FOR PURPOSES OF PARAGRAPHS (1)(C).—This clause shall not apply for purposes of determining under paragraph (1)(C) whether a building has been substantially rehabilitated.

(C) CERTIFIED REHABILITATION.—For purposes of subparagraph (B), the term "certified rehabilitation" means any rehabilitation of a certified historic structure which the Secretary of the Interior has certified to the Secretary as being consistent with the historic character of such property or the district in which such property is located.

(D) LOW-INCOME HOUSING.—For purposes of subparagraph (B), the term "low-income housing" has the meaning given such term by section 168(c)(2)(F).

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PART VI—MINIMUM TAX FOR TAX PREFERENCES

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SEC. 57. ITEMS OF TAX PREFERENCE.

(a) IN GENERAL.—For purposes of this part, the items of tax preference are—

(1) EXCLUSION OF DIVIDENDS.—Any amount excluded from gross income for the taxable year under section 116.

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(12) ACCELERATED COST RECOVERY DEDUCTION.—

(A) IN GENERAL.—With respect to each recovery property (other than [18-year] *19-year* real property and low-income housing) which is subject to a lease, the amount (if any) by which the deduction allowed under section 168(a) for the taxable year exceeds the deduction which would have been allowable for the taxable year had the property been depreciated using the straight-line method (with a half-year convention and without regard to salvage value) and a recovery period determined in accordance with the following table:

In the case of:	*The recovery period is:*
3-year property	5 years.
5-year property	8 years.
10-year property	15 years.
15-year public utility property	22 years.

(B) [18-YEAR/ *19-YEAR* REAL PROPERTY AND LOW-INCOME HOUSING.—With respect to each recovery property which is [18-year] *19-year* real property or low-income housing, the amount (if any) by which the deduction allowed under section 168(a) for the taxable year exceeds the deduction which would have been allowable for a taxable year had the property been depreciated using a straight-line method (without regard to salvage value) over a recovery period of—

(i) [18] *19* years in the case of [18-year] *19-year* real property, and

(ii) 15 years in the case of low-income housing property.

(C) SUBPARAGRAPHS (A) AND (B) INAPPLICABLE WHERE LONGER RECOVERY PERIODS APPLY.—If, pursuant to section 168(b)(3) or 168(f)(2), the recovery period for any property is longer than the recovery period for such property set forth in subparagraph (A) or (B), subparagraph (A) or (B) (as the case may be) shall not apply to such property.

(D) PARAGRAPHS (2) AND (3) SHALL NOT APPLY.—Paragraphs (2) and (3) shall not apply to recovery property.

(E) DEFINITIONS.—For purposes of this paragraph, the terms "3-year property", "5-year property", "10-year property", "15-year public utility property", "[18-year] *19-year* real property", "low-income housing", and "recovery property", shall have the same meanings given such terms under section 168.

Paragraphs (1), (3), (5), (6), (11), and (12)(A) shall not apply to a corporation other than a personal holding company (as defined in section 542).

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Subchapter B—Computation of Taxable Income

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PART VI—ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS

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SEC. 168. ACCELERATED COST RECOVERY SYSTEM.

(a) ALLOWANCE OF DEDUCATION.—There shall be allowed as a deduction for any taxable year the amount determined under this section with respect to recovery property.

(b) AMOUNT OF DEDUCTION.—

(1) IN GENERAL.—Except as otherwise provided in this section, the amount of the deduction allowable by subsection (a) for any taxable year shall be the aggregate amount determined by applying to the unadjusted basis of recovery property the applicable percentage determined in accordance with the following table:

If the recovery year is:	The applicable percentage for the class of property is:			
	3-year	5-year	10-year	15-year public utility
1	25	15	8	5
2	38	22	14	10
3	37	21	12	9
4		21	10	8
5		21	10	7
6			10	7
7			9	6
8			9	6
9			9	6
10			9	6
11				6
12				6
13				6
14				6
15				6.

(2) **[**18-YEAR**]** *19-YEAR* REAL PROPERTY—

(A) IN GENERAL.—In the case of **[**18-year**]** *19-year* real property, the applicable percentage shall be determined in accordance with a table prescribed by the Secretary. In prescribing such table, the Secretary shall—

(i) assign to the property a **[**18-year**]** *19-year* recovery period, and

(ii) assign percentages generally determined in accordance with use of the 175 percent declining balance method, switching to the method described in section 167(b)(1) at a time to maximize the deduction allowable under subsection (a).

In the case of **[**18-year**]** *19-year* real property, the applicable percentage in the taxable year in which the property is placed in service shall be determined on the basis of the

number of months (using a mid-month convention) in such year during which the property was in service.

(B) SPECIAL RULE FOR YEAR OF DISPOSITION.—In the case of a disposition of [18-year] *19-year* real property, the deduction allowable under subsection (a) for the taxable year in which the disposition occurs shall reflect only the months (using a mid-month convention) during such year the property was in service.

(3) ELECTION OF DIFFERENT RECOVERY PERCENTAGE.—

(A) IN GENERAL.—Except as provided in subsection (f)(2), in lieu of any applicable percentage under paragraph (1), (2), or (4), the taxpayer may elect, with respect to one or more classes of recovery property placed in service during the taxable year, the applicable percentage determined by use of the straight line method over the recovery period elected by the taxpayer in accordance with the following table:

In the case of:	The taxpayer may elect a recovery period of:
3-year property	3, 5, or 12 years.
5-year property	5, 12, or 25 years.
10-year property	10, 25, or 35 years.
15-year public utility property	15, 35, or 45 years.
[18-year] *19-year* real property and low-income housing.	[18, 35, or 45] *19, 35, or 45 years.*

(B) OPERATING RULES.—

(i) IN GENERAL.—Except as provided in clause (ii), the taxpayer may elect under subparagraph (A) only a single percentage for property in any class of recovery property placed in service during the taxable year. The percentage so elected shall apply to all property in such class placed in service during such taxable year and shall apply throughout the recovery period elected for such property.

(ii) REAL PROPERTY.—In the case of [18-year] *19-year* real property or low-income housing the taxpayer shall make the election under subparagraph (A) on a property-by-property basis.

(iii) CONVENTION.—Under regulations prescribed by the Secretary, the half-year convention shall apply to any election with respect to any recovery property (other than [18-year] *19-year* real property or low-income housing) with respect to which an election is made under this paragraph.

(4) LOW-INCOME HOUSING.—

(A) IN GENERAL.—In the case of low-income housing, the applicable percentage shall be determined in accordance with the table prescribed in paragraph (2) (without regard to the mid-month convention), except that in prescribing such table, the Secretary shall—

(i) assign to the property a 15-year recovery period, and

(ii) assign percentages generally determined in accordance with use of the 200 percent declining balance method, switching to the method described in section 167(b)(1) at a time to maximize the deduction allowable under subsection (a).

(B) SPECIAL RULE FOR YEAR OF DISPOSITION.—In the case of a disposition of low-income housing, the deduction allowable under subsection (a) for the taxable year in which the disposition occurs shall reflect only the months during such year the property was placed in service.

(c) RECOVERY PROPERTY.—For purposes of this title—

(1) RECOVERY PROPERTY DEFINED.—Except as provided in subsection (e), the term "recovery property" means tangible property of a character subject to the allowance for depreciation—

(A) used in a trade or business, or

(B) held for the production of income.

(2) CLASSES OF RECOVERY PROPERTY.—Each item of recovery property shall be assigned to one of the following classes of property:

(A) 3-YEAR PROPERTY.—The term "3-year property" means section 1245 class property—

(i) with a present class life of 4 years or less; or

(ii) used in connection with research and experimentation.

(B) 5-YEAR PROPERTY.—The term "5-year property" means recovery property which is section 1245 class property and which is not 3-year property, 10-year property, or 15-year public utility property.

(C) 10-YEAR PROPERTY.—The term "10-year property" means—

(i) public utility property (other than section 1250 class property or 3-year property) with a present class life of more than 18 years but not more than 25 years; and

(ii) section 1250 class property with a present class life of 12.5 years or less.

(D) [18-YEAR] 19-*YEAR* REAL PROPERTY.—The term "[18-year] *19-year* real property" means section 1250 class property which—

(i) does not have a present class life of 12.5 years or less, and

(ii) is not low-income housing.

(E) 15-YEAR PUBLIC UTILITY PROPERTY.—The term "15-year public utility property" means public utility property (other than section 1250 class property or 3-year property) with a present class life of more than 25 years.

(F) LOW-INCOME HOUSING.—The term "low-income housing" means property described in clause (i), (ii), (iii), or (iv) of section 1250(a)(1)(B).

(G) SPECIAL RULE FOR THEME PARKS, ETC.—For purposes of subparagraphs (C) and (D), a building (and its structural components) shall not be treated as having a present class

life of 12.5 years or less by reason of any use other than the use for which such building was originally placed in service.

(d) UNADJUSTED BASIS; ADJUSTMENTS.—

(1) UNADJUSTED BASIS DEFINED.—

(A) IN GENERAL.—For purposes of this section, the term "unadjusted basis" means the excess of—

(i) the basis of the property determined under part II of subchapter O of chapter 1 for purposes of determining gain (determined without regard to the adjustments described in paragraph (2) or (3) of section 1016(a)), over

(ii) the sum of—

(I) that portion of the basis for which the taxpayer properly elects amortization (including the deduction allowed under section 167(k)) in lieu of depreciation, and

(II) that portion of the basis which the taxpayer properly elects to treat as an expense under section 179.

(B) TIME FOR TAKING BASIS INTO ACCOUNT.—

(i) IN GENERAL.—The unadjusted basis of property shall be first taken into account under subsection (b) for the taxable year in which the property is placed in service.

(ii) REDETERMINATIONS.—The Secretary shall by regulation provide for the method of determining the deduction allowable under subsection (a) for any taxable year (and succeeding taxable years) in which the basis is redetermined (including any reduction under section 1017).

(2) DISPOSITIONS.—

(A) MASS ASSET ACCOUNTS.—In lieu of recognizing gain or loss under this chapter, a taxpayer who maintains one or more mass asset accounts of recovery property may, under regulations prescribed by the Secretary, elect to include in income all proceeds realized on the disposition of such property.

(B) ADJUSTMENT TO BASIS.—Except as provided under regulations prescribed by the Secretary under paragraph (7) or (10) of subsection (f), if any recovery property (other than 18-year real property or low-income housing or property with respect to which an election under subparagraph (A) is made) is disposed of, the unadjusted basis of such property shall cease to be taken into account in determining any recovery deduction allowable under subsection (a) as of the beginning of the taxable year in which such disposition occurs.

(C) DISPOSITION INCLUDES RETIREMENT.—For purposes of this subparagraph, the term "disposition" includes retirement.

(e) PROPERTY EXCLUDED FROM APPLICATION OF SECTION.—For purposes of this title—

(1) PROPERTY PLACED IN SERVICE BEFORE JANUARY 1, 1981.—The term "recovery property" does not include property placed in service by the taxpayer before January 1, 1981.

(2) CERTAIN METHODS OF DEPRECIATION.—The term "recovery property" does not include property if—

(A) the taxpayer elects to exclude such property from the application of this section, and

(B) for the first taxable year for which a deduction would (but for this election) be allowable under this section with respect to such property in the hands of the taxpayer, the property is properly depreciated under the unit-of-production method or any method of depreciation not expressed in a term of years (other than the retirement-replacement-betterment method).

(3) SPECIAL RULE FOR CERTAIN PUBLIC UTILITY PROPERTY.—

(A) IN GENERAL.—The term "recovery property" does not include public utility property (within the meaning of section 167(1)(3)(A)) if the taxpayer does not use a normalization method of accounting.

(B) USE OF NORMALIZATION METHOD DEFINED.—For purposes of subparagraph (A), in order to use a normalization method of accounting with respect to any public utility property—

(i) the taxpayer must, in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, use a method of depreciation with respect to such property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes; and

(ii) if the amount allowable as a deduction under this section with respect to such property differs from the amount that would be allowable as a deduction under section 167 (determined without regard to section 167(l)) using the method (including the period, first and last year convention, and salvage value) used to compute regulated tax expense under subparagraph (B)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

(C) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS, ETC.—

(i) IN GENERAL.—One way in which the requirements of subparagraph (B) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of subparagraph (B).

(ii) USE OF INCONSISTENT ESTIMATES AND PROJECTIONS.—The procedures and adjustments which are to be treated as inconsistent for purposes of clause (i) shall include any procedure or adjustment for ratemaking purposes which uses an estimate or projection of the taxpayer's tax expense depreciation expense, or

reserve for deferred taxes under subparagraph (B)(ii) unless such estimate or projection is also used, for ratemaking purposes, with respect to the other 2 such items and with respect to the rate base.

(iii) REGULATORY AUTHORITY.—The Secretary may be regulations prescribe procedures and adjustments (in addition to those specified in clause (ii)) which are to be treated as inconsistent for purposes of clause (i).

(D) PUBLIC UTILITY PROPERTY WHICH IS NOT RECOVERY PROPERTY.—In the case of public utility property which, by reason of this paragraph, is not treated as recovery property, the allowance for depreciation under section 167(a) shall be an amount computed using the method and period referred to in subparagraph (B)(i).

(4) CERTAIN TRANSACTIONS IN PROPERTY PLACED IN SERVICE BEFORE 1981.—

(A) SECTION 1245 CLASS PROPERTY.—The term "recovery property" does not include section 1245 class property acquired by the taxpayer after December 31, 1980, if—

(i) the property was owned or used at any time during 1980 by the taxpayer or a related person,

(ii) the property is acquired from a person who owned such property at any time during 1980, and, as part of the transaction, the user of such property does not change,

(iii) the taxpayer leases such property to a person (or a person related to such person) who owned or used such property at any time during 1980, or

(iv) the property is acquired in a transaction as part of which the user of such property does not change and the property is not recovery property in the hands of the person from which the property is so acquired by reason of clause (ii) or (iii).

For purposes of this subparagraph and subparagraph (B), property shall not be treated as owned before it is placed in service. For purposes of this subparagraph, whether the user of property changes as part of a transaction shall be determined in accordance with regulations prescribed by the Secretary.

(B) SECTION 1250 CLASS PROPERTY.—The term "recovery property" does not include section 1250 class property acquired by the taxpayer after December 31, 1980, if—

(i) such property was owned by the taxpayer or by a related person at any time during 1980;

(ii) the taxpayer leases such property to a person (or a person related to such person) who owned such property at any time during 1980; or

(iii) such property is acquired in an exchange described in section 1031, 1033, 1038, or 1039 to the extent that the basis of such property includes an amount representing the adjusted basis of other property owned by the taxpayer or a related person during 1980.

(C) CERTAIN NONRECOGNITION TRANSACTIONS.—The term "recovery property" does not include property placed in service by the transferor or distributor before January 1, 1981, which is acquired by the taxpayer after December 31, 1980, in a transaction described in section 332, 351, 361, 371(a), 374(a), 721, or 731 (or such property acquired from the transferee or acquiring corporation in a transaction described in such section), to the extent that the basis of the property is determined by reference to the basis of the property in the hands of the trasferor or distributor. In the case of property to which this subparagraph applies, rules similar to the rules described in section 381(c)(6) shall apply.

(D) RELATED PERSON DEFINED.—Except as provided in subparagraph (E), for purposes of this paragraph a person (hereinafter referred to as the related person) is related to any person if—

(i) the related person bears a relationship to such person specified in section 267(b) or section 707(b)(1), or

(ii) the related person and such person are engaged in trades or business under common control (within the meaning of subsections (a) and (b) of section 52).

For purposes of clause (i), in applying section 267(b) and section 707(b)(1) "10 percent" shall be subsituted for "50 percent". The determination of whether a person is related to another person shall be made as of the time the taxpayer acquires the property involved. In the case of the acquisition of property by any partnership which results from the termination of another partnership under section 708(b)(1)(B), the determination of whether the acquiring partnership is related to the other partnership shall be made immediately before the event resulting in such termination occurs.

(E) LIQUIDATION OF SUBSIDIARY, ETC.—For purposes of this paragraph, a corporation is not a related person to the taxpayer—

(i) if such corporation is a distributing corporation in a transaction to which section 334(b)(2)(B) applies and the stock of such corporation referred to in such subparagraph (B) was acquired by the taxpayer by purchase after December 31, 1980, or

(ii) if such corporation is liquidated in a liquidation to which section 331(a) applies and the taxpayer (or a related person) by himself or together with 1 or more other persons acquires the stock of the liquidated corporation by purchase (meeting the requirements of section 334(b)(2)(B)) after December 31, 1980.

A similar rule shall apply in the case of a deemed liquidation under section 338.

(F) ANTIAVOIDANCE RULE.—The term "recovery property" does not include property acquired by the taxpayer after December 31, 1980, which, under regulations prescribed by the Secretary, is acquired in a transaction one

of the principal purposes of which is to avoid the principles of paragraph (1) and this paragraph.

(G) REDUCTION IN UNADJUSTED BASIS.—In the case of an acquisition of property described in subparagraph (B) or (C), the unadjusted basis of the property under subsection (d) shall be reduced to the extent that such property acquired is not recovery property.

(H) ACQUISITION BY REASON OF DEATH.—Subparagraphs (A) and (B) shall not apply to the acquisition of any property by the taxpayer if the basis of the property in the hands of the taxpayer is determined under section 1014(a).

(I) SECTION 1245 CLASS PROPERTY ACQUIRED INCIDENTAL TO ACQUISITION OF SECTION 1250 CLASS PROPERTY.—Under regulations prescribed by the Secretary, subparagraph (B) shall apply (and subparagraph (A) shall not apply) to section 1245 class property which is acquired incidental to the acquisition of section 1250 class property.,

(5) FILMS AND VIDEO TAPES NOT RECOVERY PROPERTY.—The term "recovery property" shall not include any motion picture film or video tape.

(f) SPECIAL RULES FOR APPLICATION OF THIS SECTION.—For purposes of this section—

(1) COMPONENTS OF SECTION 1250 CLASS PROPERTY.—

(A) IN GENERAL.—Except as otherwise provided in this paragraph—

(i) the deduction allowable under subsection (a) with respect to any component (which is section 1250 class property) of a building shall be computed in the same manner as the deduction allowable with respect to such building, and

(ii) the recovery period for such component shall begin on the later of—

(I) the date such component is placed in service, or

(II) the date on which the building is placed in service.

(B) TRANSITIONAL RULES.—

(i) BUILDINGS PLACED IN SERVICE BEFORE 1981.—In the case of any building placed in service by the taxpayer before January 1, 1981, for purposes of applying subparagraph (A) to components of such buildings placed in service after December 31, 1980, and before March 16, 1984, the deduction allowable under subsection (a) with respct to such components shall be computed in the same manner as the deduction allowable with respect to the first such component placed in service after December 31, 1980.

(ii) BUILDINGS PLACED IN SERVICE BEFORE MARCH 16, 1984.—In the case of any building placed in service by the taxpayer before March 16, 1984, for purposes of applying subparagraph (A) to components of such buildings placed in service after March 15, 1984, [the] *and before May 9, 1985, the* deduction allowable under subsection (a) with respect to such components

shall be computed in the same manner as the deduction allowable with respect to the first such component placed in service after March 15, 1984.

(iii) BUILDINGS PLACED IN SERVICE BEFORE MAY 9, 1985.—In the case of any building placed in service by the taxpayer before May 9, 1985, for purposes of applying subparagraph (A) to components of such buildings placed in service after May 8, 1985, the deduction allowable under subsection (a) with respect to such components shall be computed in the same manner as the deduction allowable with respect to the first component placed in service after May 8, 1985.

[(iii)] *(iv)* FIRST COMPONENT TREATED AS SEPARATE BUILDING.—For purposes of clause (i) [or (ii), *, (ii), or (iii),* the method of computing the deduction allowable with respect to the first component described in such clause shall be determined as if it were a separate building.

(C) EXCEPTION FOR SUBSTANTIAL IMPROVEMENTS.—

(i) IN GENERAL.—For purposes of this paragraph, a substantial improvement shall be treated as a separate building.

(ii) SUBSTANTIAL IMPROVEMENT.—For purposes of clause (i), the term "substantial improvement" means the improvements added to capital account with respect to any building during any 24-month period, but only if the sum of the amounts added to such account during such period equals or exceeds 25 percent of the adjusted basis of the building (determined without regard to the adjustments provided in paragraphs (2) and (3) of section 1016(a)) as of the first day of such period.

(iii) IMPROVEMENTS MUST BE MADE AFTER BUILDING IN SERVICE FOR 3 YEARS.—For purposes of this paragraph, the term "substantial improvement" shall not include any improvement made before the date 3 years after the building was placed in service.

(2) RECOVERY PROPERTY USED PREDOMINANTLY OUTSIDE THE UNITED STATES.—

(A) IN GENERAL.—Except as provided in subparagraphs (B) and (C), in the case of recovery property which, during the taxable year, is used predominantly outside the United States, the recovery deduction for the taxable year shall be, in lieu of the amount determined under subsection (b), the amount determined by applying to the unadjusted basis of such property the applicable percentage determined under tables prescribed by the secretary. For purposes of the preceding sentence, in prescribing such tables, the Secretary shall—

(i) assign the property described in this subparagraph to classes in accordance with the present class life (or 12 years in the case of personal property with no present class life) of such property; and

(ii) assign percentages (taking into account the half-year convention) determined in accordance with use of the method of depreciation described in section 167(b)(2), switching to the method described in section 167(b)(1) at a time to maximize the deduction allowable under subsection (a).

(B) REAL PROPERTY—

(i) IN GENERAL.—Except as provided in subparagraph (C), in the case of [18-year] *19-year* real property or low-income housing which, during the taxable year, is predominantly used outside the United States, the recovery deduction for the taxable year shall be, in lieu of the amount determined under subsection (b), the amount determined by applying to the unadjusted basis of such property the applicable percentage determined under tables prescribed by the Secretary. For purposes of the preceding sentence in prescribing such tables, the Secretary shall—

(I) assign to the property described in this subparagraph a 35-year recovery period; and

(II) assign percentages (taking into account the next to the last sentence of subsection (b)(2)(A)) determined in accordance with use of the method of depreciation described in section 167(j)(1)(B), switching to the method described in section 167(b)(1) at a time to maximize the deduction allowable under subsection (a).

(ii) SPECIAL RULE FOR DISPOSITION.—In the case of a disposition of [18-year] *19-year* real property or low-income housing described in clause (i), subsection (b)(2)(B) shall apply.

(C) ELECTION OF DIFFERENT RECOVERY PERCENTAGE.—

(i) GENERAL RULE.—The taxpayer may elect, with respect to one or more classes of recovery property described in this paragraph, to determine the applicable percentage under this paragraph by use of the straight-line method over the recovery period determined in accordance with the following table:

* * * * * * *

Replacements made as a result of a casualty shall be RRB replacement property only to the extent that, in the case of each casualty, the replacement cost with respect to the replacement track material exceeds $50,000.

(4) MANNER AND TIME FOR MAKING ELECTIONS.—

(A) IN GENERAL.—Any election under this section shall be made for the taxable year in which the property is placed in service.

(B) ELECTION MADE ON RETURN.—

(i) IN GENERAL.—Except as provided in clause (ii), any election under this section shall be made on the taxpayer's return of the tax imposed by this chapter for the taxable year concerned.

(ii) SPECIAL RULE FOR QUALIFIED REHABILITATED BUILDINGS.—In the case of any qualified rehabilitated building (as defined in section 48(g)(1)), an election under subsection (b)(3) may be made at any time before the date 3 years after the building was placed in service.

(C) REVOCATION ONLY WITH CONSENT.—Any election under this section, once made, may be revoked only with the consent of the Secretary.

(5) SHORT TAXABLE YEARS.—In the case of a taxable year that is less than 12 months, the amount of the deduction under this section shall be an amount which bears the same relationship to the amount of the deduction, determined without regard to this paragraph, as the number of months in the short taxable year bears to 12. In such case, the amount of the deduction for subsequent taxable years shall be appropriately adjusted in accordance with regulations prescribed by the Secretary. The determination of when a taxable year begins shall be made in accordance with regulations prescribed by the Secretary. This paragraph shall not apply to any deduction with respect to any property for the first taxable year of the lessor for which an election under paragraph (8) is in effect with respect to such property. In the case of [18-year] *19-year* real property or low-income housing, the first sentence of this paragraph shall not apply to the taxable year in which the property is placed in service or disposed of.

(6) LEASEHOLD IMPROVEMENTS.—For purposes of determining whether a leasehold improvement which is recovery property shall be amortized over the term of the lease, the recovery period (taking into account any election under paragraph (2)(C) of this subsection or under subsection (b)(3) with respect to such property) of such property shall be taken into account in lieu of its useful life.

(7) SPECIAL RULE FOR ACQUISITIONS AND DISPOSITIONS IN NONRECOGNITION TRANSACTIONS.—Notwithstanding any other provision of this section, the deduction allowed under this section in the taxable year in which recovery property is acquired or is disposed of in a transaction in which gain or loss is not recognized in whole or in part shall be determined in accordance with regulations prescribed by the Secretary.

* * * * * * *

(12) LIMITATIONS ON PROPERTY FINANCED WITH TAX-EXEMPT BONDS.

(A) IN GENERAL.—Notwithstanding any other provision of this section, to the extent that any property is financed by the proceeds of an industrial development bond (within the meaning of section 103(b)(2)) the interest of which is exempt from taxation under section 103(a), the deduction allowed under subsection (a) (and any deduction allowable in lieu of the deduction allowable under subsection (a)) for any taxable year with respect to such property shall be determined under subparagraph (B).

(B) RECOVERY METHOD.—

(i) IN GENERAL.—Except as provided in clause (ii), the amount of the deduction allowed with respect to property described in subparagraph (A) shall be determined by using the straight-line method (with a half-year convention and without regard to salvage value) and a recovery period determined in accordance with the following table:

In the case of:	*The recovery period is:*
3-year property	3 years.
5-year property	5 years.
10-year property	10 years.
15-year public utility property	15 years.

(ii) [15-YEAR] *19-YEAR* REAL PROPERTY.—In the case of [15-year] *19-year* real property, the amount of the deduction allowed shall be determined by using the straight-line method (determined on the basis of the number of months in the year in which such property was in service and without regard to salvage value) and a recovery period of [15 years.] *19 years.*

(C) EXCEPTION FOR PROJECTS FOR RESIDENTIAL RENTAL PROPERTY.—Subparagraph (A) shall not apply to any recovery property which is placed in service in connection with projects for residential rental property financed by the proceeds of obligations described in section 103(b)(4)(A).

(D) EXCEPTION WHERE LONGER RECOVERY PERIOD APPLICABLE.—Subparagraph (A) shall not apply to any recovery property if the recovery period which would be applicable to such property by reason of an election under subsection (b)(3) exceeds the recovery period for such property determined under subparagraph (B).

* * * * * * *

(j) PROPERTY LEASED TO GOVERNMENTS AND OTHER TAX-EXEMPT ENTITIES.—

(1) IN GENERAL.—Notwithstanding any other provision of this section, the deduction allowed under subsection (a) (and any other deduction allowable for depreciation or amortization) for any taxable year with respect to tax-exempt use property shall be determined—

(A) by using the straight-line method (without regard to salvage value), and

(B) by using a recovery period determined under the following table:

	In the case of:	The recovery period shall be:
(I)	Property not described in subclause (II) or subclause (III).	The present class life.
(II)	Personal property with no present class life	12 years.
(III)	[18-year] *19-year* real property	40 years.

(2) OPERATING RULES.—

(A) RECOVERY PERIOD MUST AT LEAST EQUAL 125 PERCENT OF LEASE TERM.—In the case of any tax-exempt use proper-

ty, the recovery period used for purposes of paragraph (1) shall not be less than 125 percent of the lease term.

(B) Conventions.—

(i) PROPERTY OTHER THAN [18-YEAR] *19-YEAR* REAL PROPERTY.—In the case of property other than 18-year real property, the half-year convention shall apply for purposes of paragraph (1).

(ii) 18-YEAR REAL PROPERTY.—In the case of [18-year] *19-year* real property, the amount determined under paragraph (1) shall be determined on the basis of the number of months (using a mid-month, convention) in the year in which the property is in service.

(C) EXCEPTION WHERE LONGER RECOVERY PERIOD APPLIES.—Paragraph (1) shall not apply to any recovery property if the recovery period which applies to such property (without regard to this subsection) exceeds the recovery period for such property determined under this subsection.

(D) DETERMINATION OF CLASS FOR REAL PROPERTY WHICH IS NOT RECOVERY PROPERTY.—In the case of any real property which is not recovery property, for purposes of this subsection, the determination of whether such property is [18-year] *19-year* real property shall be made as if such property were recovery property.

(E) COORDINATION WITH SUBSECTION (f)(12).—Paragraph (12) of subsection (f) shall not apply to any tax-exempt use property to which this subsection applies.

(F) [18-YEAR]*19-YEAR* REAL PROPERTY.—For purposes of this subsection, the term ["18-year] "*19-year* real property" includes—

(i) low-income housing, and

(ii) any property which was treated as 15-year real property under this section (as in effect before the amendments made by the Tax Reform Act of 1984).

(3) TAX-EXEMPT USE PROPERTY.—For purposes of this subsection—

(A) PROPERTY OTHER THAN [18-*YEAR*] *19-YEAR* REAL PROPERTY.—Except as otherwise provided in this subsection, the term "tax-exempt use property" means that portion of any tangible property (other than [18-year] *19-year* real property) leased to a tax-exempt entity.

(B) [18-YEAR] *19-YEAR* REAL PROPERTY.—

(i) IN GENERAL.—In the case of [18-year] *19-year* real property, the term "tax-exempt use property" means that portion of the property leased to a tax-exempt entity in a disqualified lease.

(ii) DISQUALIFIED LEASE.—For purposes of this subparagraph, the term "disqualified lease" means any lease of the property to a tax-exempt entity, but only if—

(I) part or all of the property was financed (directly or indirectly) by an obligation the interest on which is exempt from tax under section 103 and such entity (or a related entity) participated in such financing,

(II) under such lease there is a fixed or determinable price purchase or sale option which involves such entity (or a related entity) or there is the equivalent of such an option,

(III) such lease has a lease term in excess of 20 years, or

(IV) such lease occurs after a sale (or other transfer) of the property by, or lease of the property from, such entity (or a related entity) and such property has been used by such entity (or a related entity) before such sale (or other transfer) or lease.

(iii) 35-PERCENT THRESHOLD TEST.—Clause (i) shall apply to any property only if the portion of such property leased to tax-exempt entities in disqualified leases is more than 35 percert of the property.

(iv) TREATMENT OF IMPROVEMENTS.—For purposes of this subparagraph, improvements to a property (other than land) shall not be treated as a separate property.

(v) LEASEBACKS DURING 1ST 3 MONTHS OF USE NOT TAKEN INTO ACCOUNT.—Subclause (IV) of clause (ii) shall not apply to any property which is leased within 3 months after the date such property is first used by the tax-exempt entity (or a related entity).

(C) EXCEPTION FOR SHORT-TERM LEASES.—

(i) IN GENERAL.—Property shall not be treated as tax-exempt use property merely be reason of a short-term lease.

(ii) SHORT-TERM LEASE.—For purposes of clause (i), the term "short-term lease" means any lease the term of which is—

(I) less than 3 years, and

(II) less than the greater of 1 year or 30 percent of the property's present class life.

In the case of [18-year] *19-year* real property and property with no present class life, subclause (II) shall not apply.

(D) EXCEPTION WHERE PROPERTY USED IN UNRELATRED TRADE OR BUSINESS.—The term "tax-exempt use property" shall not include any portion of a property if such portion is predominantly used by the tax-exempt entity (directly or through a partnership of which such entity is a partner) in an unrelated trade or business the income of which is subject to tax under section 511.

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Subchapter C—Corporate Distributions and Adjustments

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PART I—DISTRIBUTIONS BY CORPORATIONS

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Subpart B—Effects on Corporation

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SEC. 312. EFFECT ON EARNINGS AND PROFITS.

(a) GENERAL RULE.—* * *

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(k) EFFECT OF DEPRECIATION ON EARNINGS AND PROFITS.—

(1) GENERAL RULE.—For purposes of computing the earnings and profits of a corporation for any taxable year beginning after June 30, 1972, the allowance for depreciation (and amortization, if any) shall be deemed to be the amount which would be allowable for such year if the straight line method of depreciation had been used for each taxable year beginning after June 30, 1972.

(2) EXCEPTION.—If for any taxable year beginning after June 30, 1972, a method of depreciation was used by the taxpayer which the Secretary had determined results in a reasonable allowance under section 167(a), and which is not—

(A) a declining balance method,

(B) the sum of the years-digits method, or

(C) any other method allowable solely by reason of the application of subsection (b)(4) or (j)(1)(C) of section 167,

then the adjustment to earnings and profits for depreciation for such year shall be determined under the method so used (in lieu of under the straight line method).

(3) EXCEPTION FOR RECOVERY AND SECTION 179 PROPERTY.—

(A) RECOVERY PROPERTY.—Except as provided in subparagraphs (B) and (C), in the case of recovery property (within the meaning of section 168), the adjustment to earnings and profits for depreciation for any taxable year shall be the amount determined under the straight-line method (using a half year convention in the case of property other than the **[**18-year**]** *19-year* real property and low-income housing and without regard to salvage value) and using a recovery period determined in accordance with the following table:

In the case of:	The applicable recovery period is:
3-year property	5 years.
5-year property	12 years.
10-year property	25 years.
18-year real property and low-income housing	40 years.
15-year public utility property	35 years.

For purposes of this subparagraph, no adjustment shall be allowed in the year of disposition (except with respect to 18-year real property and low-income housing), and rules similar to the rules under the next to the last sentence of section 168(b)(2)(A) and section 168(b)(2)(B) shall apply.

(B) TREATMENT OF AMOUNTS DEDUCTIBLE UNDER SECTION 179.—For purposes of computing the earnings and profits of a corporation, any amount deductible under section 179 shall be allowed as a deduction ratably over the period of 5 years (beginning with the year for which such amount is deductible under section 179).

(C) FLEXIBILITY.—In any case where a different recovery percentage is elected under section 168(b)(3) or (f)(2)(C) based on a recovery period longer than the recovery period provided in subparagraph (A), the adjustment to earnings and profits shall be based on such longer period under rules similar to those provided in subparagraph (A).

(4) CERTAIN FOREIGN CORPORATIONS.—The provisions of paragraphs (1) and (3) shall not apply in computing the earnings and profits of a foreign corporation for any taxable year for which less than 20 percent of the gross income from all sources of such corporation is derived from sources within the United States. In determining the earnings and profits of such corporation in the case of recovery property (within the meaning of section 168), the rules of section 168(f)(2) shall apply.

(5) BASIS ADJUSTMENT NOT TAKEN INTO ACCOUNT.—In computing the earnings and profits of a corporation for any taxable year, the allowance for depreciation (and amortization, if any) shall be computed without regard to any basis adjustment under section 48(q).

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Subchapter E—Accounting Periods and Methods of Accounting

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PART III—ADJUSTMENTS

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SEC. 483. INTEREST ON CERTAIN DEFERRED PAYMENTS.

(a) AMOUNT CONSTITUTING INTEREST.—For purposes of this title, in the case of any payment—

(1) under any contract for the sale or exchange of any property, and

(2) to which this section applies,

there shall be treated as interest that portion of the total unstated interest under such contract which, as determined in a manner consistent with the method of computing interest under section 1272(a), is properly allocable to such payment.

(b) TOTAL UNSTATED INTEREST.—For purposes of this section, the term "total unstated interest" means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of—

(1) the sum of the payments to which this section applies which are due under the contract, over

(2) the sum of the present values of such payments and the present values of any interest payments due under the contract.

For purposes of the preceding sentence, the present value of a payment shall be determined under the rules of section 127(b)(2) using a discount rate equal to [120 percent of] the applicable Federal rate determined under section 1274(d).

(c) PAYMENTS TO WHICH SUBSECTION (a) APPLIES.—

(1) IN GENERAL.—Except as provided in subsection (d), this section shall apply to any payment on account of the sale or exchange of property which constitutes part or all of the sales price and which is due more than 6 months after the date of such sale or exchange under a contract—

(A) under which some or all of the payments are due more than 1 year after the date of such sale or exchange, and

[(B) under which, using a discount rate equal to 110 percent of the applicable Federal rate determined under section 1274(d), there is total unstated interest.]

(B) under which there is total unstated interest.

(2) TREATMENT OF OTHER DEBT INSTRUMENTS.—For purposes of this section, a debt instrument of the purchaser which is given in consideration for the sale or exchange of property shall not be treated as a payment, and any payment due under such debt instrument shall be treated as due under the contract for the sale or exchange.

(3) DEBT INSTRUMENT DEFINED.—For purposes of this subsection, the term "debt instrument" has the meaning given such term by section 1275(a)(1).

* * * * * * *

[(e) INTEREST RATES IN CASE OF SALES OF PRINCIPAL RESIDENCE OR FARM LANDS.—

[(1) IN GENERAL.—In the case of any debt instrument arising from a sale or exchange to which this subsection applies, subsections (b) and (c)(1)(B) shall be applied by using, in lieu of the discount rates determined under such subsections, discount rates determined under subsections (b) and (c)(1), respectively, of this section as it was in effect before the amendments made by the Tax Reform Act of 1984.

[(2) SALES OR EXCHANGES TO WHICH SUBSECTION APPLIES.—This subsection shall apply—

[(A) to any sale or exchange by an individual of his principal residence (within the meaning of section 1034), and

[(B) to any sale or exchange by a person of land used by such person as a farm (within the meaning of section 6420(c)(2)).

[(3) LIMITATION.—Paragraph (1) shall apply to any sale or exchange by an individual of his principal residence (within the meaning of section 1034), only to the extent the purchase price of such residence does not exceed $250,000. For purposes of the preceding sentence, the purchase price of a residence shall be determined without regard to this section.]

[(f)]*(e)* MAXIMUM RATE OF INTEREST ON CERTAIN TRANSFERS OF LAND BETWEEN RELATED PARTIES.—

(1) IN GENERAL.—In the case of any qualified sale, the discount rate used in determining the total unstated interest rate under subsection (b) shall not exceed [7]*6* percent, compounded semiannually.

(2) QUALIFIED SALE.—For purposes of this subsection, the term "qualified sale" means any sale or exchange of land by an individual to a member of such individual's family (within the meaning of section 267(c)(4)).

(3) $500,000 LIMITATION.—Paragraph (1) shall not apply to any qualified sale between individuals made during any calendar year to the extent that the sales price for such sale (when added to the aggregate sale price for prior qualified sales between such individuals during the calendar year) exceeds $500,000.

(4) NONRESIDENT ALIEN INDIVIDUALS.—Paragraph (1) shall not apply to any sale or exchange if any party to such sale or exchange is a nonresident alien individual.

[(g)]*(f)* REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section including regulations providing for the application of this section in the case of—

(1) any contract for the sale or exchange of property under which the liability for, or the amount or due date of, a payment cannot be determined at the time of the sale or exchange, or

(2) any change in the liability for, or the amount or due date of, any payment (including interest) under a contract for the sale or exchange of property.

[(h) CROSS REFERENCE.—

[For special rules in the case of the borrower under certain loans for personal use, see section 1275(b).]

(g) CROSS REFERENCES.—

(1) For treatment of assumptions, see section 1274(c)(4).

(2) For special rules for certain transactions where stated principal amount does not exceed $4,000,000, see section 1274A.

(3) For special rules in case of the borrower under certain loans for personal use, see section 1275(b).

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Subchapter P—Capital Gains and Losses

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PART IV—SPECIAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

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SEC. 1245. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE PROPERTY.

(a) GENERAL RULE.—

(1) * * *

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(5) SECTION 1245 RECOVERY PROPERTY.—For purposes of this section, the term "section 1245 recovery property" means recovery property (within the meaning of section 168) other than—

(A) [*19-year*] real property and low-income housing which is residential rental property (as defined in section 167(j)(2)(B)),

(B) [*19-year*] real property and low-income housing which is described in section 168(f)(2),

(C) [*19-year*] real property and low-income housing with respect to which an election under subsection (b)(3) of section 168 to use a different recovery percentage is in effect, and

(D) low-income housing (within the meaning of section 168(c)(2)(F)).

If only a portion of a building (or other structure) is section 1245 recovery property, gain from any disposition of such building (or other structure) shall be allocated first to the portion of the building (or other structure) which is section 1245 recovery property (to the extent of the amount which may be treated as ordinary income under this section) and then to the portion of the building or other structure which is not section 1245 recovery property.

(6) SPECIAL RULE FOR QUALIFIED LEASED PROPERTY.—In any case in which—

(A) the lessor of qualified leased property (within the meaning of section 168(f)(8)(D)) is treated as the owner of such property for purposes of this subtitle under section 168(f)(8), and

(B) the lessee acquires such property,

the recomputed basis of the lessee under this subsection shall be determined by taking into account any adjustments which would be taken into account in determining the recomputed basis of the lessor.

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PART V—SPECIAL RULES FOR BONDS AND OTHER DEBT INSTRUMENTS

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Subpart A—Original Issue Discount

Sec. 1271. Treatment of amounts received on retirement or sale or exchange of debt instruments.
Sec. 1272. Current inclusion in income of original discount.
Sec. 1273. Determination of amount of original issue discount.
Sec. 1274. Determination of issue price in the case of certain debt instruments issued for property.
Sec. 1274A. Special rules for certain transactions where stated principal amount does not exceed $4,000,000.
Sec. 1275. Other definitions and special rules.

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SEC. 1274. DETERMINATION OF ISSUE PRICE IN THE CASE OF CERTAIN DEBT INSTRUMENTS ISSUED FOR PROPERTY

(a) IN GENERAL.—In the case of any debt instrument to which this section applies, for purposes of this subpart, the issue price shall be—

(1) where there is adequate stated interest, the stated principal amount, or

(2) in any other case, the imputed principal amount.

(b) IMPUTED PRINCIPAL AMOUNT.—For purposes of this section—

(1) IN GENERAL.—Except as provided in paragraph (3), the imputed principal amount of any debt instrument shall be equal to the sum of the present values of all payments due under such debt instrument.

(2) DETERMINATION OF PRESENT VALUE.—For purposes of paragraph (1), the present value of a payment shall be determined in the manner provided by regulations prescribed by ther Secretary—

(A) as of the date of the sale or exchange, and

(B) by using a discount rate equal to [120 percent of] the applicable Federal rate, compounded semiannually.

(3) FAIR MARKET VALUE RULE IN POTENTIALLY ABUSIVE SITUATIONS.—

(A) IN GENERAL.—In the case of any potentially abusive situation, the imputed principal amount of any debt instrument received in exchange to property shall be the fair market value of such property adjusted to take into account other consideration involved in the transaction.

(B) POTENTIALLY ABUSIVE SITUATION DEFINED.—For purposes of subparagraph (A), the term "potentially abusive situation" means—

(i) a tax shelter (as defined in section 6661(b)(2)(C)(ii), and

(ii) any other situation which, by reason of—

(I) recent sales transactions,

(II) nonrecourse financing,

(III) financing with a term in excess of the economic life of the property, or

(IV) other circumstances,

is of a type which the Secretary specifies by regulations as having potential for tax avoidance.

(c) DEBT INSTRUMENTS TO WHICH SECTION APPLIES—

(1) IN GENERAL.—Except as otherwise provided in this subsection, this section shall apply to any debt instrument given in consideration for the sale or exchange of property if—

(A) the stated redemption price at maturity for such debt instrument exceeds—

(i) where there is adequate state interest, the stated principal amount, or

[(ii) in any other case, the testing amount, and]

(ii) in any other other case, the imputed principal amount of such debt instrument determined under subsection (b), and

(B) some or all of the payments due under such debt instrument are due more than 6 months after the date of such sale or exchange.

(2) ADEQUATE STATED INTEREST.—For purposes of this section, there is adequate stated interest with respect to any debt instrument if the stated principal amount for such debt instrument is less than or equal to [the testing amount.] *the imputed principal amount of such debt instrument determined under subsection (b).*

[(3) TESTING AMOUNT.—For purposes of this section, the term "testing amount" means, with respect to any debt instrument, the imputed principal amount of such debt instrument which would be determined under subsection (b) (including paragraph (3) thereof) if a discount rate equal to 110 percent of the applicable Federal rate were used.]

[(4)] *(3)* EXCEPTIONS.—This section shall not apply to—

(A) SALES FOR LESS THAN $1,000,000 OF FARMS BY INDIVIDUALS OR SMALL BUSINESSES.—

(i) IN GENERAL.—Any debt instrument arising from the sale or exchange of a farm (within the meaning of section 6420(c)(2))—

(I) by an individual, estate, or testamentary trust,

(II) by a corporation which as of the date of the sale or exchange is a small business corporation (as defined in section 1244(c)(3)), or

(III) by a partnership which as of the date of the sale or exchange meets requirements similar to those of section 1244(c)(3).

(ii) $1,000,000 LIMITATION.—Clause (i) shall apply only if it can be determined at the time of the sale or exchange that the sales price cannot exceed $1,000,000. For purposes of the preceding sentence, all sales and exchanges which are part of the same transaction (or a series of related transactions) shall be treated as 1 sale or exchange.

(B) SALES OF PRINCIPAL RESIDENCES.—Any debt instrument arising from the sale or exchange by an individual of his principal residence (within the meaning of section 1034).

(C) SALES INVOLVING TOTAL PAYMENTS $250,000 OR LESS.—

(i) IN GENERAL.—Any debt instrument arising from the sale or exchange of property if the sum of the following amounts does not exceed $250,000:

(I) the aggregate amount of the payments due under such debt instrument and all other debt instruments received as consideration for the sale or exchange, and

(II) the aggregate amount of any other consideration to be received for the sale or exchange.

(ii) CONSIDERATION OTHER THAN DEBT INSTRUMENT TAKEN INTO ACCOUNT AT FAIR MARKET VALUE.—For purposes of clause (i), any consideration (other than a

debt instrument) shall be taken into account at its fair market value.

(iii) AGGREGATION OF TRANSACTIONS.—For purposes of this subparagraph, all sales and exchanges which are part of the same transaction (or a series of related transactions) shall be treated as 1 sale or exchange.

(D) DEBT INSTRUMENTS WHIHC ARE PUBLICLY TRADED OR ISSUED FOR PUBLICLY TRADED PROPERTY.—Any debt instrument to which section 1273(b)(3) applies.

(E) CERTAIN SALES OF PATENTS.—In the case of any transfer described in section 1235(a) (relating to sale or exchange of patents), any amount contingent on the productivity, use, or disposition of the property transferred.

(F) SALES OR EXCHANGES TO WHICH SECTION 483(e)[f] APPLIES.—Any debt instrument to the extent section 483(e)[f] (relating to certain land transfers between related persons) applies to such instrument.

(4) EXCEPTION FOR ASSUMPTIONS.—If any person—

(A) in connection with the sale or exchange of property, assumes any debt instrument, or

(B) acquires any property subject to any debt instrument, this section and section 483 shall not apply to such debt instrument by reason of such assumption (or such acquisition) unless the terms and conditions of such debt instrument are modified (or the nature of the transaction is changed) in connection with the assumption (or acquisition).

(d) DETERMINATION OF APPLICABLE FEDERAL RATE.—For purposes of this section—

(1) APPLICABLE FEDERAL RATE.—

(A) IN GENERAL.—

In the case of a debt instrument with a term of:	The applicable Federal rate is:
Not over 3 years	The Federal short-term rate.
Over 3 years but not over 9 years	The Federal mid-term rate.
Over 9 years	The Federal long-term rate.

[(B) DETERMINATION OF RATES.—Within 15 days after the close of—

[(i) the 6-month period ending on September 30 of any calendar year, or

[(ii) the 6-month period ending on March 31 of any calendar year,

the Secretary shall determine the Federal short-term rate, mid-term rate, and long-term rate for such 6-month period.

[(C) EFFECTIVE DATE OF DETERMINATION.—Any Federal rate determined under subparagraph (A) shall—

[(i) apply during the 6-month period beginning on January 1 of the succeeding calendar year in the case of a determination made under subparagraph (B)(i), and

[(ii) apply during the 6-month period beginning on July 1 of the calendar year in the case of a determination made under subparagraph (B)(ii).

[(D) FEDERAL RATE FOR ANY 6-MONTH PERIOD.—For purposes of this paragraph—

[(i) FEDERAL SHORT-TERM RATE.—The Federal short-term rate for any 6-month period shall be the rate determined by the Secretary based on the average market yield (during such 6-month period) on outstanding marketable obligations of the United States with remaining periods to maturity of 3 years or less.

[(ii) FEDERAL MID-TERM AND LONG-TERM RATES.—The Federal mid-term rate and long-term rate shall be determined in accordance with the principles of clause (i).]

(B) DETERMINATION OF RATES.—During each calendar month, the Secretary shall determine the Federal short-term rate, mid-term rate, and long-term rate which shall apply during the following calendar month.

(C) FEDERAL RATE FOR ANY CALENDAR MONTH.—For purposes of this paragraph—

(i) FEDERAL SHORT-TERM RATE.—The Federal short-term rate shall be the rate determined by the Secretary based on the average market yield (during any 1-month period selected by the Secretary and ending in the calendar month in which the determination is made) on outstanding marketable obligations of the United States with remaining periods to maturity of 3 years or less.

(ii) FEDERAL MID-TERM AND LONG-TERM RATES.—The Federal mid-term and long-term rate shall be determined in accordance with the principles of clause (i).

(D) LOWER RATE PERMITTED IN CERTAIN CASES.—The Secretary may by regulations permit a rate to be used with respect to any debt instrument which is lower than the applicable Federal rate if the taxpayer establishes to the satisfaction of the Secretary that such lower rate is based on the same principles as the applicable Federal rate and is appropriate for the term of such instrument.

[(2) RATE APPLICABLE TO ANY SALE OR EXCHANGE.—In the case of any sale or exchange, the determination of the applicable Federal rate shall be made as of the first day on which there is a binding contract in writing for the sale or exchange.]

(2) LOWEST 3-MONTH RATE APPLICABLE TO ANY SALE OR EXCHANGE.—

(A) IN GENERAL.—In the case of any sale or exchange, the applicable Federal rate shall be the lowest 3-month rate.

(B) LOWEST 3-MONTH RATE.—For purposes of subparagraph (A), the term 'lowest 3-month rate' means the lowest of the applicable Federal rates in effect for any month in the 3-calendar-month period ending with the 1st calendar

month in which there is a binding contract in writing for such sale or exchange.

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SEC. 1274A. SPECIAL RULES FOR CERTAIN TRANSACTIONS WHERE STATED PRINCIPAL AMOUNT DOES NOT EXCEED $4,000,000.

(a) LOWER DISCOUNT RATE.—In the case of any qualified debt instrument—

(1) if the stated principal amount of such instrument does not exceed $2,000,000, the discount rate used for purposes of sections 483 and 1274 shall not exceed 9 percent, compounded semiannually, and

(2) if the stated principal amount of such instrument exceeds $2,000,000, the discount rate used for purposes of sections 483 and 1274 shall not exceed the blended rate determined under subsection (c), compounded semiannually.

(b) QUALIFIED DEBT INSTRUMENT DEFINED.—

(1) IN GENERAL.—For purposes of this section, the term "qualified debt instrument" means any debt instrument given in consideration for the sale or exchange of property (other than new section 38 property) if the stated principal amount of such instrument does not exceed $4,000,000.

(2) NEW SECTION 38 PROPERTY.—The term "new section 38 property" has the meaning given such term by section 48(b).

(c) BLENDED RATE.—For the purposes of this section—

(1) IN GENERAL.—The blended rate determined under this subsection with respect to any qualified debt instrument is the weighted average of—

(A) 9 percent with respect to the qualified amount of such debt instrument, and

(B) the applicable Federal rate determined under section 1274(d) with respect to the stated principal amount in excess of the qualified amount.

(2) QUALIFIED AMOUNT.—The term "qualified amount" means $2,000,000 reduced by the excess of the stated principal amount over $2,000,000.

(d) ELECTION TO USE CASH METHOD WHERE STATED PRINCIPAL AMOUNT DOES NOT EXCEED $2,000,000.—

(1) IN GENERAL.—In the case of any cash method debt instrument—

(A) section 1274 shall not apply, and

(B) interest in such debt instrument shall be taken into account by both the borrower and the lender under the cash receipts and disbursements method of accounting.

(2) CASH METHOD DEBT INSTRUMENT.—For purposes of paragraph (1), the term "cash method debt instrument" means any qualified debt instrument if—

(A) the stated principal amount does not exceed $2,000,000.

(B) the lender does not use an accrual method of accounting and is not a dealer with respect to the property sold or exchanged,

(C) section 1274 would have applied to such instrument but for an election under this subsection, and

(D) an election under this subsection is jointly made with respect to such debt instrument by the borrower and lender.

(3) SUCCESSORS BOUND BY ELECTION.—

(A) IN GENERAL.—Except as provided in subparagraph (B), paragraph (1) shall apply to any successor to the borrower or lender with respect to a cash method debt instrument.

(B) EXCEPTION WHERE LENDER TRANSFERS DEBT INSTRUMENT TO ACCRUAL METHOD TAXPAYER.—If the lender (or any successor) transfers any cash method debt instrument to a taxpayer who uses an accrual method of accounting, this paragraph shall not apply with respect to such instrument for periods after such transfer.

(4) FAIR MARKET VALUE RULE IN POTENTIALLY ABUSIVE SITUATIONS.—In the case of any cash method debt instrument, section 483 shall be applied as if it included provisions similar to the provisions of section 1274(b)(3).

(e) OTHER SPECIAL RULES.—

(1) AGGREGATION RULES.—For purposes of this section—

(A) all sales or exchanges which are part of the same transaction (or a series of related transactions) shall be treated as 1 sale or exchange, and

(B) all debt instruments arising from the same transaction (or a series of related transactions) shall be treated as 1 debt instrument.

(2) INFLATION ADJUSTMENTS.—

(A) IN GENERAL.—In the case of any debt instrument arising out of a sale or exchange during any calendar year after 1988, each dollar amount contained in the preceding provisions of this section shall be increased by the inflation adjustment for such calendar year. Any increase under the preceding sentence shall be rounded to the nearest multiple of $100 (or, if such increase is a multiple of $50, such increase shall be increased to the nearest multiple of $100).

(B) INFLATION ADJUSTMENT.—For purposes of subparagraph (A), the inflation adjustment for any calendar year is the percentage (if any) by which—

(i) the CPI for the preceding calendar year exceeds

(ii) the CPI for calendar year 1987.

For purposes of the preceding sentence, the CPI for any calendar year is the average of the Consumer Price Index as of the close of the 12-month period ending on September 30 of such calendar year.

(f) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection, including—

(1) regulations coordinating the provisions of this section with other provisions of this title,

(2) regulations necessary to prevent the avoidance of tax through the abuse of the provisions of subsection (d), and

(3) regulations relating to the treatment of transfers of cash method debt instruments.

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